

DIGI INTERNATIONAL INC

Form 10-Q

May 10, 2010

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

FORM 10-Q

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

For the quarterly period ended: March 31, 2010

OR

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

For the transition period from _____ to _____.

Commission file number: 1-34033

DIGI INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

41-1532464

(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 No
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 No

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. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No
On April 30, 2010, there were 24,926,980 shares of the registrant's \$.01 par value Common Stock outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS****DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)**

| | Three months ended March 31, | | Six months ended March 31, | |
|---|--|-----------|----------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands, except per common share data) | | | |
| Net sales | \$ 45,076 | \$ 40,085 | \$ 88,044 | \$ 81,446 |
| Cost of sales (exclusive of amortization of purchased and core technology shown separately below) | 21,254 | 19,908 | 41,417 | 38,977 |
| Amortization of purchased and core technology | 1,074 | 1,008 | 2,166 | 2,052 |
| Gross profit | 22,748 | 19,169 | 44,461 | 40,417 |
| Operating expenses: | | | | |
| Sales and marketing | 9,603 | 8,976 | 18,843 | 18,601 |
| Research and development | 7,078 | 6,196 | 13,564 | 13,170 |
| General and administrative | 4,224 | 3,398 | 8,382 | 7,281 |
| Restructuring | (352) | | (352) | |
| Total operating expenses | 20,553 | 18,570 | 40,437 | 39,052 |
| Operating income | 2,195 | 599 | 4,024 | 1,365 |
| Other income, net: | | | | |
| Interest income | 90 | 404 | 183 | 984 |
| Interest expense | (32) | (50) | (84) | (135) |
| Other income (expense) | 301 | 41 | 263 | (195) |
| Total other income, net | 359 | 395 | 362 | 654 |
| Income before income taxes | 2,554 | 994 | 4,386 | 2,019 |
| Income tax provision | 868 | 279 | 1,501 | 288 |
| Net income | \$ 1,686 | \$ 715 | \$ 2,885 | \$ 1,731 |
| Net income per common share: | | | | |
| Basic | \$ 0.07 | \$ 0.03 | \$ 0.12 | \$ 0.07 |
| Diluted | \$ 0.07 | \$ 0.03 | \$ 0.12 | \$ 0.07 |

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Weighted average common shares:

| | | | | |
|---------|--------|--------|--------|--------|
| Basic | 24,816 | 24,953 | 24,758 | 25,169 |
| Diluted | 25,213 | 25,195 | 25,072 | 25,439 |

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)**

| | March 31, 2010 | September 30, 2009 |
|--|-----------------------------------|-----------------------|
| | (in thousands, except share data) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 29,433 | \$ 48,434 |
| Marketable securities | 47,290 | 22,311 |
| Accounts receivable, net | 22,996 | 19,032 |
| Inventories | 25,987 | 26,619 |
| Other | 6,065 | 6,259 |
| Total current assets | 131,771 | 122,655 |
| Marketable securities, long-term | 4,267 | 5,063 |
| Property, equipment and improvements, net | 16,506 | 16,678 |
| Identifiable intangible assets, net | 22,895 | 26,877 |
| Goodwill | 85,587 | 86,558 |
| Other | 970 | 1,117 |
| Total assets | \$ 261,996 | \$ 258,948 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 8,583 | \$ 5,567 |
| Accrued compensation | 5,098 | 3,275 |
| Accrued warranty | 965 | 970 |
| Deferred payment on acquisition | | 2,966 |
| Restructuring | 225 | 721 |
| Other | 3,062 | 3,035 |
| Total current liabilities | 17,933 | 16,534 |
| Income taxes payable | 4,922 | 4,893 |
| Deferred tax liabilities | 3,408 | 4,331 |
| Deferred payment on acquisition | 2,862 | 2,812 |
| Other noncurrent liabilities | 626 | 792 |
| Total liabilities | 29,751 | 29,362 |
| 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; 28,573,894 and 28,409,198 shares issued | 286 | 284 |

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| | | |
|---|------------|------------|
| Additional paid-in capital | 183,470 | 181,282 |
| Retained earnings | 85,593 | 82,708 |
| Accumulated other comprehensive loss | (9,392) | (6,527) |
| Treasury stock, at cost, 3,649,216 and 3,708,302 shares | (27,712) | (28,161) |
| Total stockholders' equity | 232,245 | 229,586 |
| Total liabilities and stockholders' equity | \$ 261,996 | \$ 258,948 |

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)

| | Six months ended March 31, | |
|--|----------------------------|----------|
| | 2010 | 2009 |
| | (in thousands) | |
| Operating activities: | | |
| Net income | \$ 2,885 | \$ 1,731 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation of property, equipment and improvements | 1,334 | 1,203 |
| Amortization of identifiable intangible assets and other assets | 3,869 | 3,662 |
| Stock-based compensation | 1,824 | 1,842 |
| Excess tax benefits from stock-based compensation | (39) | (42) |
| Deferred income tax benefit | (848) | (1,540) |
| Restructuring | (352) | |
| Other | (3) | 40 |
| Changes in operating assets and liabilities | 285 | (7,694) |
| | | |
| Net cash provided by (used in) operating activities | 8,955 | (798) |
| | | |
| Investing activities: | | |
| Purchase of marketable securities | (28,510) | (7,647) |
| Proceeds from maturities of marketable securities | 4,334 | 32,063 |
| Deferred cash payout for acquisition of Spectrum Design Solutions, Inc. | (3,000) | |
| Purchase of property, equipment, improvements and certain other intangible assets, net of proceeds from sale | (1,469) | (1,666) |
| | | |
| Net cash (used in) provided by investing activities | (28,645) | 22,750 |
| | | |
| Financing activities: | | |
| Payments on capital lease obligations | (7) | (139) |
| Excess tax benefits from stock-based compensation | 39 | 42 |
| Proceeds from stock option plan transactions and other | 1,032 | 120 |
| Proceeds from employee stock purchase plan transactions | 445 | 529 |
| Purchase of treasury stock | | (6,150) |
| | | |
| Net cash provided by (used in) financing activities | 1,509 | (5,598) |
| | | |
| Effect of exchange rate changes on cash and cash equivalents | (820) | (1,989) |
| | | |
| Net (decrease) increase in cash and cash equivalents | (19,001) | 14,365 |
| Cash and cash equivalents, beginning of period | 48,434 | 14,176 |

| | | |
|--|-----------|-----------|
| Cash and cash equivalents, end of period | \$ 29,433 | \$ 28,541 |
|--|-----------|-----------|

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, 2009 as filed with the SEC (2009 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 2009 Financial Statements, but do not include all disclosures required by accounting principles generally accepted in the United States of America.

Recently Issued Accounting Pronouncements

In February 2010, the Financial Accounting Standards Board (FASB) issued an amendment to the accounting standards related to the recognition and disclosure requirements for subsequent events. This amendment removes the requirement to disclose the date through which subsequent events have been evaluated in both issued and revised financial statements for companies that file financial statements with the SEC. This amendment was effective immediately. We evaluate subsequent events through the date our financial statements are filed with the SEC.

In January 2010, the FASB issued an amendment to the accounting standards related to fair value measurements. This guidance requires disclosure of transfers into and out of Level 1 and Level 2 fair value measurements and the reasons for those transfers and also requires more detailed disclosure about the activity within Level 3 fair value measurements. We adopted this guidance as of January 1, 2010, except for the additional disclosures required for the Level 3 reconciliation which is effective for us beginning with the quarter ending December 31, 2011. We have provided the requisite disclosure for the transfers into and out of Level 1 and Level 2 fair value measurements in our consolidated financial statements for the period ended March 31, 2010. We do not expect the impact of the Level 3 additional disclosures to have a material impact to our consolidated financial statements.

In October 2009, the FASB issued an amendment to the accounting standards that provides guidance for identifying separate deliverables in a revenue-generating transaction where multiple deliverables exist, and for allocating and recognizing revenue based on those separate deliverables. This guidance is expected to result in more multiple-deliverable arrangements being separable than under current guidance. This amendment is effective for revenue arrangements entered into or materially modified in our fiscal year beginning October 1, 2010. Early adoption is permitted. We are currently evaluating the impact this amendment will have on our consolidated financial statements.

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

In October 2009, the FASB issued an amendment to the accounting standards related to certain revenue arrangements that include software elements. This standard clarifies the existing accounting guidance such that tangible products that contain both software and non-software components that function together to deliver the product's essential functionality shall be excluded from the scope of the software revenue recognition accounting standards. Accordingly, sales of these products may fall within the scope of other revenue recognition accounting standards or may now be within the scope of this standard and may require an allocation of the arrangement consideration for each element of the arrangement. This amendment is effective for revenue arrangements entered into or materially modified in our fiscal year beginning October 1, 2010. We are currently evaluating the impact this amendment will have on our consolidated financial statements.

2. NET INCOME PER COMMON SHARE

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

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

| | Three months ended March 31, | | Six months ended March 31, | |
|---|------------------------------|---------|----------------------------|----------|
| | 2010 | 2009 | 2010 | 2009 |
| Numerator: | | | | |
| Net income | \$ 1,686 | \$ 715 | \$ 2,885 | \$ 1,731 |
| Denominator: | | | | |
| Denominator for basic net income per common share weighted average shares outstanding | 24,816 | 24,953 | 24,758 | 25,169 |
| Effect of dilutive securities: | | | | |
| Employee stock options and employee stock purchase plan | 397 | 242 | 314 | 270 |
| Denominator for diluted net income per common share adjusted weighted average shares | 25,213 | 25,195 | 25,072 | 25,439 |
| Net income per common share, basic | \$ 0.07 | \$ 0.03 | \$ 0.12 | \$ 0.07 |
| Net income per common share, diluted | \$ 0.07 | \$ 0.03 | \$ 0.12 | \$ 0.07 |

Potentially dilutive shares related to stock options to purchase 2,495,421 and 2,865,921 common shares for the three and six month periods ended March 31, 2010, respectively, and 4,587,240 and 4,365,675 common shares for the three and six month periods ended March 31, 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.

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

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

| | Three months ended March | | Six months ended March 31, | |
|---|--------------------------|----------|----------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income | \$ 1,686 | \$ 715 | \$ 2,885 | \$ 1,731 |
| Other comprehensive income (loss): | | | | |
| Change in foreign currency translation adjustment | (2,136) | (1,713) | (2,846) | (9,614) |
| Change in unrealized gain (loss) on investments | (52) | 10 | 7 | (3) |
| Less income tax (provision) benefit | 20 | (4) | (3) | 1 |
| Reclassification of gain included in net income | (36) | | (36) | |
| Less income tax (provision) benefit | 14 | | 14 | |
| Comprehensive income (loss) | \$ (504) | \$ (992) | \$ 21 | \$ (7,885) |

4. SELECTED BALANCE SHEET DATA

| (in thousands) | March 31, 2010 | September 30, 2009 |
|---|-------------------|-----------------------|
| Accounts receivable, net: | | |
| Accounts receivable | \$ 23,512 | \$ 19,656 |
| Less allowance for doubtful accounts | 516 | 624 |
| | \$ 22,996 | \$ 19,032 |
| Inventories: | | |
| Raw materials | \$ 22,173 | \$ 21,359 |
| Work in process | 594 | 452 |
| Finished goods | 3,220 | 4,808 |
| | \$ 25,987 | \$ 26,619 |
| Other accrued expenses: | | |
| Accrued professional fees | \$ 529 | \$ 696 |
| Deferred gain on building sale short-term | 254 | 276 |
| Other accrued expenses | 2,279 | 2,063 |
| | \$ 3,062 | \$ 3,035 |

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

5. ACQUISITION**MobiApps Holdings Private Limited**

On June 8, 2009, we acquired substantially all the assets of MobiApps Holdings Private Limited (MobiApps), a developer of machine-to-machine (M2M) communications technology focusing on satellite, cellular, and hybrid

satellite/cellular solutions. MobiApps has locations in India, Singapore and in the U.S. Pursuant to the terms of the asset purchase agreements, Digi acquired the U.S. assets located in Herndon, Virginia. In addition, we established Digi Wireless Singapore Pte. Ltd. and Digi m2m Solutions India Private Limited, which acquired the assets of MobiApps affiliate companies, located in Singapore and India, respectively. The acquisition was a cash transaction for \$3.0 million. An additional \$0.5 million may be payable at the end of fiscal 2010, contingent on the achievement of certain performance milestones. We have determined that the MobiApps acquisition is not material to our consolidated results of operations or financial condition. Therefore, pro forma financial information is not presented.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****6. MARKETABLE SECURITIES**

Our marketable securities consist of certificates of deposit, corporate bonds and government municipal bonds. We obtain quoted market prices and trading activity for each security we hold, 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. Thirty-two of the securities we held were trading slightly below our amortized cost basis at March 31, 2010. We determined each decline in value to be temporary as we expect to receive full par value of our investments upon maturity and have no indication from the security issuers of default or any other factor leading us to believe the decline would be other-than-temporary. 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. We monitor our investment values on an ongoing basis and record them at fair value as discussed in Note 7.

During the fourth quarter of fiscal 2008, we recorded an other-than-temporary impairment of \$1,014,900 on the bond issued by Lehman Brothers, (the Lehman Brothers Bond) with a par amount of \$1,194,000. The resulting value of \$179,100 for the security became its new cost basis as of September 30, 2008. We sold a portion of the bond in fiscal 2009, leaving the remaining value of the Lehman Brothers Bond as of September 30, 2009 at \$134,100. We sold the remainder of the bond in January 2010 for \$169,860 and recognized a gain of \$35,760 on this sale during the second quarter of fiscal 2010, reflecting the difference between the remaining value and the selling price.

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 were comprised of the following:

| At March 31, 2010 (in thousands) | Amortized Cost (1) | Unrealized Gains | Unrealized Losses (2) | Fair Value (1) |
|------------------------------------|-----------------------|---------------------|--------------------------|----------------|
| Current marketable securities: | | | | |
| Corporate bonds | \$ 25,574 | \$ 198 | \$ (214) | \$ 25,558 |
| Certificates of deposit | 13,543 | 10 | (13) | 13,540 |
| Government municipal bonds | 8,194 | 3 | (5) | 8,192 |
| Current marketable securities | 47,311 | 211 | (232) | 47,290 |
| Non-current marketable securities: | | | | |
| Corporate bonds | 2,157 | | (12) | 2,145 |
| Government municipal bonds | 2,131 | | (9) | 2,122 |
| Non-current marketable securities | 4,288 | | (21) | 4,267 |
| Total marketable securities | \$ 51,599 | \$ 211 | \$ (253) | \$ 51,557 |

(1) Included in amortized cost and fair value is purchased and accrued interest of \$538,085.

(2) The aggregate related fair value of securities with

unrealized
losses as of
March 31, 2010
was
\$26,555,744.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****6. MARKETABLE SECURITIES (CONTINUED)**

| At September 30, 2009 (in thousands) | Amortized Cost (1) | Unrealized Gains | Unrealized Losses (3) | Fair Value (1) |
|--------------------------------------|-----------------------|---------------------|--------------------------|----------------|
| Current marketable securities: | | | | |
| Corporate bonds (2) | \$ 4,236 | \$ 18 | \$ | \$ 4,254 |
| Certificates of deposit | 10,022 | 4 | (1) | 10,025 |
| Government municipal bonds | 8,023 | 11 | (2) | 8,032 |
| Current marketable securities | 22,281 | 33 | (3) | 22,311 |
| Non-current marketable securities: | | | | |
| Corporate bonds | 5,107 | | (44) | 5,063 |
| Total marketable securities | \$ 27,388 | \$ 33 | \$ (47) | \$ 27,374 |

(1) Included in amortized cost and fair value is purchased and accrued interest of \$263,883.

(2) The Lehman Brothers Bond is included in amortized cost at a fair value of \$134,100.

(3) The aggregate related fair value of securities with unrealized losses as of September 30, 2009 was \$9,009,428.

7. 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. See the section below titled *Level 3 Valuation Techniques* for further discussion of how we determine fair value for investments classified as Level 3.

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis

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; however, the definition of fair value is applied using the above guidance.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****7. FAIR VALUE MEASUREMENTS (CONTINUED)**

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

| | Total carrying value at March 31, 2010 | Fair Value Measurements at March 31, 2010 Using: | | |
|---|---|--|---|--|
| | | Quoted price in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Cash equivalents: | | | | |
| Money market | \$ 12,780 | \$ 12,780 | \$ | \$ |
| Available-for-sale marketable securities: | | | | |
| Corporate bonds | 27,703 | | 27,703 | |
| Certificates of deposit | 13,540 | | 13,540 | |
| Government municipal bonds | 10,314 | | 10,314 | |
| Total cash equivalents and marketable securities measured at fair value | \$ 64,337 | \$ 12,780 | \$ 51,557 | \$ |

Cash equivalents are measured at fair value using quoted market prices in active markets for identical assets. All other marketable securities are measured at fair value using similar assets and are classified within Level 2 of the valuation hierarchy.

Prior to January 1, 2010, we classified certain investments as Level 1 and upon further review, have subsequently determined to classify them as Level 2. As a result, we transferred \$34.9 million of assets previously classified within Level 1 to Level 2 on January 1, 2010. It was determined that the fair value of such investments is based off of indices and matrices for similar assets, as defined within Level 2 valuation techniques, and not identical assets, as defined within Level 1 valuation techniques. Our policy for determining when to recognize transfers between levels is based on the actual date of the event or change in circumstances that caused the transfer. This transfer had no impact on the fair value of our investments as stated in any of the periods presented.

Level 3 Valuation Techniques

Financial assets are categorized within Level 3 of the hierarchy when 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 also may 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. We have no financial assets valued with Level 3 inputs as of March 31, 2010. We sold the remaining portion of the Lehman Brothers Bond in January 2010 for \$169,860 and recognized a gain of \$35,760 on this sale, reflecting the difference between the remaining value and the selling price.

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis that used significant unobservable inputs (Level 3) (in thousands):

| | | |
|--|----|-------|
| Balance at December 31, 2009 | \$ | 134 |
| Sale of security | | (170) |
| Realized gain recorded in other income (expense) | | 36 |

Balance at March 31, 2010

\$

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****7. FAIR VALUE MEASUREMENTS (CONTINUED)**

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. The fair value of our securities could change significantly based on changes in market conditions and continued uncertainties in the credit markets. If these uncertainties continue or if these securities experience credit rating downgrades, we may incur impairment charges for securities in our investment portfolio.

8. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS

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

| | March 31, 2010 | | | September 30, 2009 | | |
|--------------------------------|-----------------------|---------------|-----------|-----------------------|---------------|-----------|
| | Gross carrying amount | Accum. amort. | Net | Gross carrying amount | Accum. amort. | Net |
| Purchased and core technology | \$ 46,186 | \$ (36,829) | \$ 9,357 | \$ 46,583 | \$ (34,893) | \$ 11,690 |
| License agreements | 2,840 | (2,501) | 339 | 2,840 | (2,464) | 376 |
| Patents and trademarks | 9,495 | (6,054) | 3,441 | 9,292 | (5,536) | 3,756 |
| Customer maintenance contracts | 700 | (569) | 131 | 700 | (534) | 166 |
| Customer relationships | 17,288 | (8,099) | 9,189 | 17,607 | (7,334) | 10,273 |
| Non-compete agreements | 1,028 | (590) | 438 | 1,041 | (425) | 616 |
| Total | \$ 77,537 | \$ (54,642) | \$ 22,895 | \$ 78,063 | \$ (51,186) | \$ 26,877 |

Amortization expense was \$2.0 million and \$1.8 million for the three months ended March 31, 2010 and 2009, respectively, and \$3.9 million and \$3.7 million for the six months ended March 31, 2010 and 2009, respectively. Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2010 and the five succeeding fiscal years is as follows (in thousands):

| | |
|-------------------|----------|
| 2010 (six months) | \$ 3,718 |
| 2011 | 6,607 |
| 2012 | 4,567 |
| 2013 | 3,042 |
| 2014 | 2,288 |
| 2015 | 1,240 |

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

| | Six months ended March 31, | |
|---|----------------------------|-----------|
| | 2010 | 2009 |
| Beginning balance, October 1 | \$ 86,558 | \$ 86,578 |
| Foreign currency translation adjustment | (971) | (3,456) |
| Ending balance, March 31 | \$ 85,587 | \$ 83,122 |

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

Income taxes have been provided at an effective rate of 34.2% and 14.3% for the six month periods ended March 31, 2010 and 2009, respectively.

In the six month period ended March 31, 2009, we recorded a discrete tax benefit of \$0.4 million resulting from the enactment on October 3, 2008 of the retroactive extension of the research and development tax credit for activity from January 1, 2008 to September 30, 2008. The benefit resulting from such discrete tax event reduced our effective tax rate by 20.5 percentage points for the six month period ended March 31, 2009.

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

| | |
|---|----------|
| Uncertain tax positions as of December 31, 2009 | \$ 4,121 |
| Decreases related to: | |
| Settlements | (32) |
| Expiration of the statute of limitations | (13) |
| Uncertain tax positions as of March 31, 2010 | \$ 4,076 |

The total amount of unrecognized tax benefits that, if recognized, would affect our effective tax rate is \$3.3 million. We recognize interest and penalties related to income tax matters in income tax expense. During the six months ended March 31, 2010, we recognized an immaterial amount of interest and penalties. As of March 31, 2010, we had \$0.8 million in accrued interest and penalties on our consolidated balance sheet.

It is reasonably possible that there are tax positions taken in prior years that may be realized within in the next 12 months that will decrease the total amount of unrecognized tax benefits. This is due to the expiration of the statute of limitations for both domestic and foreign tax returns and an ongoing U.S. federal income tax audit. As the federal audit is not final, an estimate of the reduction in unrecognized tax benefits cannot be made.

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. Certain open tax years are expected to close in future periods that may result in adjustments to our income tax balances in those periods that are material to our consolidated financial position and results of operations.

10. 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 90 days 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.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****10. FINANCIAL GUARANTEES (CONTINUED)**

The following table summarizes the activity associated with the product warranty accrual (in thousands):

| Fiscal year | Three months ended March 31, | | | |
|-------------|------------------------------|----------------------|---------------------|------------------------|
| | Balance at January 1 | Warranties issued | Settlements made | Balance at March 31 |
| 2010 | \$ 952 | \$ 229 | \$ (216) | \$ 965 |
| 2009 | \$ 1,230 | \$ 123 | \$ (210) | \$ 1,143 |

| Fiscal year | Six months ended March 31, | | | |
|-------------|----------------------------|----------------------|---------------------|------------------------|
| | Balance at October 1 | Warranties issued | Settlements made | Balance at March 31 |
| 2010 | \$ 970 | \$ 425 | \$ (430) | \$ 965 |
| 2009 | \$ 1,214 | \$ 344 | \$ (415) | \$ 1,143 |

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.

11. CONTINGENCIES*Contingent obligations*

There have been no additional developments in In re Initial Public Offering Securities Litigation since our Annual Report on Form 10-K for the year ended September 30, 2009. 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 March 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.

We received allegations regarding possible violations of our gifts, travel and entertainment policy in the Asia Pacific region by a few employees. We are conducting an investigation of these policy and corresponding internal control issues, including any possible related violations of applicable law, such as the Foreign Corrupt Practices Act, under the direction of the Audit Committee, utilizing outside counsel. We voluntarily disclosed this matter to the United States Department of Justice and the Securities and Exchange Commission. Our Chief Financial Officer resigned during the course of this investigation. Our investigation is not complete; however, as of the date of this filing we are not aware of any material impact to our reported consolidated financial statements. We cannot predict the outcome of this matter 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. However, we do anticipate additional general and administrative expense in the quarter ending June 30, 2010 related to the cost of the investigation, which is expected to be material.

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.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****12. 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. The restructuring included the closing of an engineering facility in Long Beach, California, and the relocation and consolidation of the manufacturing facility in Davis, California to our Minneapolis, Minnesota headquarters. We paid a lease cancellation fee for one of the leased facilities in Davis and had vacated the facility as of the end of fiscal 2009. We continue to maintain non-manufacturing activities at the remaining leased facility in Davis, California. As a result of these initiatives, during the third quarter of fiscal 2009 we recorded a \$2.0 million charge, which consisted of \$1.8 million for employee termination costs for 86 positions and \$0.2 million for contract termination fees and other relocation costs.

All of the 86 positions were vacated in fiscal 2009. The employee termination costs include severance and the associated costs of continued medical benefits and outplacement services. The other restructuring expenses include contract termination fees for non-renewal of lease terms relating to one of the facilities in Davis, California and relocation expenses for employees.

A summary of the restructuring charges and other activity within the restructuring accrual is listed below (in thousands):

| | Employee Termination Costs | Other | Total |
|-------------------------------|----------------------------------|--------|--------|
| Balance at September 30, 2009 | \$ 620 | \$ 101 | \$ 721 |
| Restructuring charge | 75 | | 75 |
| Payments | (208) | (11) | (219) |
| Write-downs | (352) | | (352) |
| Balance at March 31, 2010 | \$ 135 | \$ 90 | \$ 225 |

During the second quarter of fiscal 2010, we eliminated \$0.4 million of the restructuring accrual as a result of lower than expected costs associated with continued medical benefits and lower than expected relocation costs.

The remaining liability is mostly related to continued medical benefits as part of the American Recovery and Reinvestment Act of 2009 (ARRA), which provides for premium reductions for health benefits under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). The ARRA was amended by the Department of Defense Appropriations Act of 2010 on December 19, 2009, which provides an additional six months (from nine to fifteen months) for receiving the subsidy. We recorded an additional accrual of \$0.1 million for the additional six months of continued medical benefits during the three months ended December 31, 2009. We expect the remaining liability to be settled by the end of the second quarter of fiscal 2011.

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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, 2009, 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 our management 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, 2009. 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, 2009.

Table of Contents**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.

Net sales increased from \$40.1 million in the second quarter of fiscal 2009 to \$45.1 million in the second quarter of fiscal 2010, an increase of \$5.0 million, or 12.5%. Net sales in the second quarter of fiscal 2010 also increased by \$2.1 million, or 4.9%, compared to the first quarter of fiscal 2010. Net income and net income per diluted share increased from \$0.7 million, or \$0.03 per diluted share, in the second quarter of fiscal 2009 to \$1.7 million, or \$0.07 per diluted share, in the second quarter of fiscal 2010, an increase of \$1.0 million, or \$0.04 per diluted share. Net income and net income per diluted share in the second quarter of fiscal 2010 also exceeded net income and net income per diluted share in the first quarter of fiscal 2010 by \$0.5 million, or \$0.02 per diluted share. We believe that increases in net sales and net income over both the second quarter of fiscal 2009 and the first quarter of fiscal 2010 are indicative of an upturn in our business and stabilization of economic conditions. Revenue in North America increased by \$5.8 million, or 27.9%, in the second fiscal quarter of 2010 compared to the year ago comparable quarter, and increased sequentially from the first quarter of fiscal 2010 by \$1.0 million, or 3.9%. Revenue in all other geographic regions decreased by \$0.8 million, or 4.1%, in the second fiscal quarter of 2010 compared to the year ago comparable quarter, and increased sequentially from the first quarter of fiscal 2010 by \$1.1 million, or 6.4%.

Our wireless product net sales grew from \$14.0 million, or 34.9% of net sales, in the second quarter of fiscal 2009 compared to \$15.8 million, or 35.0% of net sales, in the second quarter of fiscal 2010, an increase of 12.9%. Wireless product net sales increased from \$27.6 million, or 33.7% of net sales, in the first six months of fiscal 2009 compared to \$30.9 million, or 35.1% of net sales, in the first six months of fiscal 2010.

Our business was negatively impacted by the effects of the severe economic downturn in fiscal 2009. We experienced a reduction in demand for our products in all geographic locations. In response to the depressed economic conditions, we put in place a restructuring plan that included various cost reduction actions, including closing our manufacturing facility in Davis, California and consolidation of manufacturing operations in our Minneapolis plant. As a result, we believe the deployment of this restructuring plan has contributed to the improvements in our gross margin. Our gross margins have improved from 47.8% and 49.6% for the three and six months ended March 31, 2009, respectively, to 50.5% for both the three and six months ended March 31, 2010.

We suspended our non-sales incentive compensation program for fiscal 2009, for both executive management as well as a large part of the employee base. This program was reinstated at a reduced level for fiscal 2010. We also reduced our sales commission program in the last half of fiscal 2009 and we have fully restored the program in fiscal 2010. 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. We also are actively managing our supply chain to ensure that our key sources of supply are intact.

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

The following table sets forth selected information derived from our interim condensed consolidated statements of operations (dollars in thousands):

| | Three months ended March 31, | | | | % | Six months ended March 31, | | | | % |
|---|------------------------------|--------|-----------|--------|------------------------|----------------------------|--------|-----------|--------|------------------------|
| | 2010 | | 2009 | | increase (decrease) | 2010 | | 2009 | | increase (decrease) |
| Net sales | \$ 45,076 | 100.0% | \$ 40,085 | 100.0% | 12.5% | \$ 88,044 | 100.0% | \$ 81,446 | 100.0% | 8.1% |
| Cost of sales (exclusive of amortization of purchased and core technology shown separately below) | 21,254 | 47.1 | 19,908 | 49.7 | 6.8 | 41,417 | 47.0 | 38,977 | 47.9 | 6.3 |
| Amortization of purchased and core technology | 1,074 | 2.4 | 1,008 | 2.5 | 6.5 | 2,166 | 2.5 | 2,052 | 2.5 | 5.6 |
| Gross profit | 22,748 | 50.5 | 19,169 | 47.8 | 18.7 | 44,461 | 50.5 | 40,417 | 49.6 | 10.0 |
| Operating expenses | 20,553 | 45.6 | 18,570 | 46.3 | 10.7 | 40,437 | 45.9 | 39,052 | 47.9 | 3.5 |
| Operating income | 2,195 | 4.9 | 599 | 1.5 | N/M | 4,024 | 4.6 | 1,365 | 1.7 | N/M |
| Interest income and other, net | 359 | 0.8 | 395 | 1.0 | (9.1) | 362 | 0.4 | 654 | 0.8 | (44.6) |
| Income before income taxes | 2,554 | 5.7 | 994 | 2.5 | N/M | 4,386 | 5.0 | 2,019 | 2.5 | N/M |
| Income tax provision | 868 | 2.0 | 279 | 0.7 | N/M | 1,501 | 1.7 | 288 | 0.4 | N/M |
| Net income | \$ 1,686 | 3.7% | \$ 715 | 1.8% | N/M% | \$ 2,885 | 3.3% | \$ 1,731 | 2.1% | 66.7% |

N//M = not meaningful

NET SALES

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

| (\$ in thousands) | Three months ended March 31, | | | | % | Six months ended March 31, | | | | % |
|-------------------|------------------------------|-------|-----------|-------|------------------------|----------------------------|-------|-----------|-------|------------------------|
| | 2010 | | 2009 | | increase (decrease) | 2010 | | 2009 | | increase (decrease) |
| Non-embedded | \$ 24,910 | 55.3% | \$ 22,715 | 56.7% | 9.7% | \$ 49,807 | 56.6% | \$ 46,055 | 56.5% | 8.1% |

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| | | | | | | | | | | |
|-----------------|-----------|--------|-----------|--------|-------|-----------|--------|-----------|--------|------|
| Embedded | 20,166 | 44.7 | 17,370 | 43.3 | 16.1 | 38,237 | 43.4 | 35,391 | 43.5 | 8.0 |
| Total net sales | \$ 45,076 | 100.0% | \$ 40,085 | 100.0% | 12.5% | \$ 88,044 | 100.0% | \$ 81,446 | 100.0% | 8.1% |

Non-embedded

Our non-embedded revenue increased by \$2.2 million or 9.7% for the three months ended March 31, 2010 compared to the three months ended March 31, 2009 and increased by \$3.8 million or 8.1% for the six months ended March 31, 2010 compared to the six months ended March 31, 2009. The increases resulted primarily from an increase in cellular products, serial servers, wireless communication adaptors and USB products, which were offset by decreases in net sales of Sarian-branded products and serial cards. Most of the increase in our non-embedded net sales took place in the North American and Asian regions primarily resulting from a favorable product mix, offset by a decrease in the European, Middle Eastern and African (EMEA) and Latin American regions. In fiscal 2009, net sales of Sarian-branded products, located in the EMEA region were higher due to a large sale to a legacy customer of Sarian Systems, Inc. in the second quarter of fiscal 2009.

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

Our embedded revenue increased by \$2.8 million or 16.1% for the three months ended March 31, 2010 compared to the three months ended March 31, 2009, and increased by \$2.8 million or 8.0% for the six months ended March 31, 2010 compared to the six months ended March 31, 2009. Most of the increase in our embedded net sales took place in the North American, Asian and Latin American regions primarily related to net sales of modules and incremental net sales of satellite-related products due to our acquisition of MobiApps in the third quarter of fiscal 2009. This was partially offset by a decrease in net sales in the EMEA region primarily relating to a chip that was phased out during fiscal 2009.

The following summarizes our net sales by geographic region:

| (\$ in thousands) | Three months ended | | \$ | % | Six months ended | | \$ | % |
|-------------------|--------------------|----------------|---------------------|---------------------|------------------|----------------|---------------------|---------------------|
| | March 31, 2010 | March 31, 2009 | increase (decrease) | increase (decrease) | March 31, 2010 | March 31, 2009 | increase (decrease) | increase (decrease) |
| North America (1) | \$ 26,515 | \$ 20,724 | \$ 5,791 | 27.9% | \$ 52,040 | \$ 43,869 | \$ 8,171 | 18.6% |
| EMEA (2) | 12,347 | 14,934 | (2,587) | (17.3) | 23,368 | 28,262 | (4,894) | (17.3) |
| Asia countries | 5,238 | 3,776 | 1,462 | 38.7 | 10,573 | 7,610 | 2,963 | 38.9 |
| Latin America | 976 | 651 | 325 | 49.9 | 2,063 | 1,705 | 358 | 21.0 |
| Total net sales | \$ 45,076 | \$ 40,085 | \$ 4,991 | 12.5% | \$ 88,044 | \$ 81,446 | \$ 6,598 | 8.1% |

(1) Includes Satellite net sales of \$0 and \$100,605 for the three and six months ended March 31, 2010, respectively.

(2) Includes Satellite net sales of \$360,497 and \$841,632 for the three and six months ended March 31, 2010, respectively.

The fluctuation of foreign currency rates for the three month and six month periods ended March 31, 2010 had a favorable impact on net sales of \$0.3 million and \$0.7 million, respectively, compared to the same periods a year ago.

GROSS MARGIN

Gross margins were 50.5% for both the three and six months ended March 31, 2010, compared to 47.8% and 49.6% for the three and six months ended March 31, 2009, respectively. The increase in the gross margin for both the three and six months ended March 31, 2010 as compared to the same period a year ago was primarily due to lower manufacturing expenses, favorable product mix and product cost reductions. A large sale to a legacy customer of

Sarian Systems, Inc. reduced gross margin by 1.6% in the second quarter of fiscal 2009. Gross margin in fiscal 2010 was also favorably impacted by the restructuring in the third quarter of fiscal 2009.

OPERATING EXPENSES

Total operating expenses increased by \$2.0 million and \$1.4 million for the three and six months ended March 31, 2010, respectively, as compared to the same periods a year ago. The increase is primarily the result of increases in incentive compensation and commissions of \$1.7 million and \$1.2 million for the three and six months ended March 31, 2010, respectively, as compared to the same periods a year ago and incremental operating expenses of \$0.7 million and \$1.3 million for the three and six months ended March 31, 2010, respectively, related to our acquisition of MobiApps in June 2009. This was offset by decreases in employee compensation and benefits primarily as a result of the restructuring of \$0.7 million and \$1.4 million for the three and six months ended March 31, 2010, respectively, as compared to the same period a year ago.

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

| (\$ in thousands) | Three months ended March 31, | | | | \$ | Six months ended March 31, | | | | \$ |
|----------------------------|------------------------------|-------|-----------|-------|--------------------------|----------------------------|-------|-----------|-------|--------------------------|
| | 2010 | | 2009 | | (increase (decrease)) | 2010 | | 2009 | | (increase (decrease)) |
| Sales and marketing | \$ 9,603 | 21.3% | \$ 8,976 | 22.4% | \$ 627 | \$ 18,843 | 21.4% | \$ 18,601 | 22.8% | \$ 242 |
| Research and development | 7,078 | 15.7 | 6,196 | 15.4 | 882 | 13,564 | 15.4 | 13,170 | 16.2 | 394 |
| General and administrative | 4,224 | 9.4 | 3,398 | 8.5 | 826 | 8,382 | 9.5 | 7,281 | 8.9 | 1,101 |
| Restructuring | (352) | (0.8) | | 0.0 | (352) | (352) | (0.4) | | 0.0 | (352) |
| Total operating expenses | \$ 20,553 | 45.6% | \$ 18,570 | 46.3% | \$ 1,983 | \$ 40,437 | 45.9% | \$ 39,052 | 47.9% | \$ 1,385 |

The net increase of \$0.6 million in sales and marketing expenses for the three months ended March 31, 2010 as compared to March 31, 2009 was primarily due to an increase of \$0.4 million in compensation-related expenses and \$0.3 million due to the incremental ongoing expenses resulting from our acquisition of MobiApps. For the six months ended March 31, 2010 as compared to March 31, 2009, the net increase of \$0.2 million in sales and marketing expenses was primarily due to an increase of \$0.4 million due to the incremental ongoing expenses resulting from the MobiApps acquisition, offset by a reduction of \$0.2 million for other sales and marketing expenses.

The net increase of \$0.9 million in research and development expenses for the three months ended March 31, 2010 compared to March 31, 2009 was due primarily to an increase of \$0.5 million pertaining to outside testing and various development projects, \$0.2 million for compensation-related expenses and \$0.2 million related to incremental ongoing research and development expenses resulting from the MobiApps acquisition. Research and development expenses for the six months ended March 31, 2010 increased \$0.4 million compared to the same period a year ago due primarily to an increase of \$0.3 million in outside service expense primarily for agency testing and various development projects, incremental ongoing expenses of \$0.5 million resulting from the MobiApps acquisition and \$0.2 million in other research and development expenses, offset by a decrease of \$0.6 million of compensation-related expenses.

The net increase in general and administrative expenses of \$0.8 million for the three months ended March 31, 2010 compared to the three months ended March 31, 2009 was primarily due to an increase of compensation-related expenses of \$0.4 million, \$0.2 million of incremental ongoing expenses due to the acquisition of MobiApps and a \$0.2 million increase in other general and administrative expenses. For the six months ended March 31, 2010 compared to March 31, 2009, the net increase in general and administrative expenses of \$1.1 million was due primarily to an increase of \$0.4 million in compensation-related expenses, \$0.3 million in other general and administrative expenses and \$0.4 million in incremental ongoing expenses due to the acquisition of MobiApps.

During the second quarter of fiscal 2010, we eliminated \$0.4 million of the restructuring accrual as a result of lower than expected costs associated with continued medical benefits and lower than expected relocation costs.

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

Other income, net was \$0.4 million for both the three and six months ended March 31, 2010 compared to \$0.4 million and \$0.7 million for the three and six months ended March 31, 2009, respectively. For the three months ended March 31, 2010 compared to March 31, 2009, interest income, net decreased \$0.3 million, offset by an increase of \$0.3 million related to foreign currency transaction net gains. The decrease of \$0.3 million for the six months ended March 31, 2010, as compared to the same period a year ago, was due to a \$0.8 million reduction in interest income, offset by an increase of \$0.5 million related to foreign currency transaction net gains. We earned an average interest rate of 0.6% for both the three and six months ended March 31, 2010, respectively, compared to 2.8% and 3.3% for the three and six months ended March 31, 2009. The average invested balance for the three and six months ended March 31, 2010 was \$67.9 million and \$67.4 million, respectively, and for the three and six months ended March 31, 2009 the average invested balance was \$53.5 million and \$57.1 million, respectively.

INCOME TAXES

For the six months ended March 31, 2010, income taxes have been provided at an effective rate of 34.2% compared to 14.3% for the six months ended March 31, 2009. We recorded a discrete tax benefit of \$0.4 million during the first quarter of fiscal 2009 resulting from the enactment on October 3, 2008 of the retroactive extension of the research and development tax credit for activity from January 1, 2008 to September 30, 2008. We expect our annualized 2010 income tax rate, before the impact of discrete items, to be approximately 33% to 35%.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations principally with funds generated from operations. At March 31, 2010, we had cash, cash equivalents and short-term marketable securities of \$76.7 million compared to \$70.7 million at September 30, 2009. Our working capital (current assets less total current liabilities) increased \$7.7 million to \$113.8 million at March 31, 2010 compared to \$106.1 million at September 30, 2009. We anticipate total fiscal 2010 capital expenditures will be approximately \$3.5 million.

Net cash provided by operating activities was \$9.0 million for the six months ended March 31, 2010 as compared to net cash used by operating activities of \$0.8 million for the six months ended March 31, 2009, resulting in a net increase of \$9.8 million. This increase was primarily due to cash provided by working capital in accounts primarily related to inventories. An increase in inventories for the six months ended March 31, 2009 resulted from certain forecasted sales being deferred to future quarters, pre-builds of new products and strategic inventory purchases. Cash provided by working capital accounts also increased in the six months ended March 31, 2010 compared to the same period a year ago due to net increases in both accounts payable and accrued liabilities, offset by a decrease related to accounts receivable.

Net cash used in investing activities was \$28.6 during the six months ended March 31, 2010 as compared to net cash provided by investing activities of \$22.8 million during the six months ended March 31, 2009. The increase was due to the timing of settlements and maturities of marketable securities. We also paid \$3.0 million to the former shareholders of Spectrum Design Solutions, Inc. (Spectrum) for a deferred cash payout related to our acquisition of Spectrum.

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

LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)

Cash provided by financing activities was \$1.5 million during the six months ended March 31, 2010 compared to a cash usage of \$5.6 million during the same period a year ago, or a net increase of \$7.1 million. We used \$6.1 million for the purchase of treasury stock during the six months ended March 31, 2009 and also received \$0.8 million more in proceeds from stock option and employee stock purchase plan transactions during the first half of fiscal 2010 as compared to the same period a year ago.

We believe the strength of our capital structure provides us with stable access to capital markets. Historically we have only accessed capital markets on a short-term basis in order to finance our acquisitions. We may need to access capital markets for future acquisitions. We believe that current financial resources, cash generated from operations, and our capacity for debt and/or equity financing will be sufficient to meet currently anticipated growth plans, including capital expenditures, working capital investments and acquisitions.

The contractual obligations disclosed in our Annual Report on Form 10-K for the year ended September 30, 2009 did not materially change through March 31, 2010. In January 2010, we paid \$3.0 million to the former shareholders of Spectrum as provided in the purchase agreement.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In February 2010, the Financial Accounting Standards Board (FASB) issued an amendment to the accounting standard related to the recognition and disclosure requirements for subsequent events. This amendment removes the requirement to disclose the date through which subsequent events have been evaluated in both issued and revised financial statements for companies that file financial statements with the Securities and Exchange Commission (SEC). This amendment was effective immediately. We evaluate subsequent events through the date our financial statements are filed with the SEC.

In January 2010, the FASB issued an amendment to the accounting standards related to fair value measurements. This guidance requires disclosure of transfers into and out of Level 1 and Level 2 fair value measurements and the reasons for those transfers and also requires more detailed disclosure about the activity within Level 3 fair value measurements. We adopted this guidance as of January 1, 2010, except for the additional disclosures required for the Level 3 reconciliation which is effective for us beginning with the quarter ending December 31, 2011. We have provided the requisite disclosure for the transfers into and out of Level 1 and Level 2 fair value measurements in our consolidated financial statements for the period ended March 31, 2010. We do not expect the impact of the Level 3 additional disclosures to have a material impact to our consolidated financial statements.

In October 2009, the FASB issued an amendment to the accounting standards that provides guidance for identifying separate deliverables in a revenue-generating transaction where multiple deliverables exist, and for allocating and recognizing revenue based on those separate deliverables. This guidance is expected to result in more multiple-deliverable arrangements being separable than under current guidance. This amendment is effective for revenue arrangements entered into or materially modified in our fiscal year beginning October 1, 2010. Early adoption is permitted. We are currently evaluating the impact this amendment will have on our consolidated financial statements.

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

In October 2009, the FASB issued an amendment to the accounting standards related to certain revenue arrangements that include software elements. This standard clarifies the existing accounting guidance such that tangible products that contain both software and non-software components that function together to deliver the product's essential functionality shall be excluded from the scope of the software revenue recognition accounting standards. Accordingly, sales of these products may fall within the scope of other revenue recognition accounting standards or may now be within the scope of this standard and may require an allocation of the arrangement consideration for each element of the arrangement. This amendment is effective for revenue arrangements entered into or materially modified in our fiscal year beginning October 1, 2010. We are currently evaluating the impact this amendment will have on our consolidated financial statements.

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 and Japanese Yen. As a result, we are exposed to foreign currency transaction risk associated with certain sales transactions being denominated in Euros, British Pounds or Japanese Yen, and foreign currency translation risk as the financial position and operating results of our foreign subsidiaries are translated into U.S. Dollars for consolidation. We have not implemented a formal hedging strategy to reduce foreign currency risk.

For the six months ended March 31, 2010 and 2009, we had approximately \$36.0 million and \$37.6 million, respectively, of net sales to foreign customers including export sales, of which \$12.8 million and \$18.0 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 and Yen to the U.S. Dollar:

| | Six months ended March 31, | | % increase |
|---------------|----------------------------|--------|------------|
| | 2010 | 2009 | (decrease) |
| Euro | 1.4326 | 1.3141 | 9.0% |
| British Pound | 1.5985 | 1.5087 | 6.0% |
| Yen | 0.0111 | 0.0106 | 5.0% |

A 10% change from the first six months of fiscal year 2010 average exchange rate for the Euro, British Pound and Yen to the U.S. Dollar would have resulted in a 1.5% increase or decrease in net sales and a 1.7% 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.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (CONTINUED)
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 credit exposure related to the fair value of our securities, which could change significantly based on changes in market conditions and continued uncertainties in the credit markets. If these uncertainties continue or if these securities experience credit rating downgrades, we may incur impairment charges for securities in our investment portfolio.

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.

Table of Contents**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

The disclosures set forth in Note 11 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

The risk factor set forth below updates the risk factors section previously disclosed in Item 1A of Part I of the Company's Annual Report on Form 10-K for the year ended September 30, 2009.

We are investigating potential violations of our gifts, travel and entertainment policy, as well as corresponding internal control issues, including any possible violations of law, such as the Foreign Corrupt Practices Act. The outcome and impact of this investigation are unknown at this time.

We received allegations regarding possible violations of our gifts, travel and entertainment policy in the Asia Pacific region by a few employees. We are conducting an investigation of these policy and corresponding internal control issues, including any possible related violations of applicable law, such as the Foreign Corrupt Practices Act, under the direction of the Audit Committee, utilizing outside counsel. We voluntarily disclosed this matter to the United States Department of Justice and the Securities and Exchange Commission. Our Chief Financial Officer resigned during the course of this investigation. Our investigation is not complete; however, as of the date of this filing we are not aware of any material impact to our reported consolidated financial statements. We cannot predict the outcome of this matter 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. However, we do anticipate additional general and administrative expense in the quarter ending June 30, 2010 related to the cost of the investigation, which is expected to be material.

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

Our Annual Meeting of Stockholders was held on January 25, 2010. Of the 24,700,896 shares of Digi common stock entitled to vote at the meeting, 21,893,001 shares were present at the meeting in person or by proxy. The stockholders voted on the following:

- a) The following individuals designated by our Board of Directors as nominees for director were elected for a three-year term, with voting as follows:

| Nominee | Total Votes For | Withhold Authority | Broker Non-Vote |
|----------------|--------------------|-----------------------|--------------------|
| Guy C. Jackson | 9,879,923 | 8,760,181 | 3,252,897 |
| Ahmed Nawaz | 10,068,360 | 8,571,744 | 3,252,897 |

- b) Proposal to approve the Digi International Inc. 2000 Omnibus Stock Plan, as Amended and Restated as of December 4, 2009. The proposal passed on a vote of 9,820,744 in favor, 8,730,774 against, 88,586 abstentions and 3,252,897 broker non-votes.
- c) Proposal to approve the Digi International Inc. Employee Stock Purchase Plan, as Amended and Restated as of December 4, 2009. The proposal passed on a vote of 18,277,562 in favor, 336,573 against, 25,969 abstentions and 3,252,897 broker non-votes.
- d) Proposal to ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending September 30, 2010. The proposal passed on a vote of 21,764,364 in favor, 108,870 against, 19,767 abstentions and no broker non-votes.

In addition, the terms of the following directors continued after the meeting:

Directors with a term ending in 2011: Joseph T. Dunsmore and Bradley J. Williams

Directors with a term ending in 2012: Kenneth E. Millard and William N. Priesmeyer

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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) |
| 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 Corporate Controller and Acting Principal Financial Officer |
| 32 | Section 1350 Certification |

(1) Incorporated by reference to Exhibit 3(a) to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972)

(2) Incorporated by reference to Exhibit 3(b) to the Company's Form 10-Q for the quarter ended June 30, 2008 (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: May 10, 2010

By: /s/ Brenda Mueller
Brenda Mueller
Corporate Controller and Acting Principal
Financial Officer
(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 |
| 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 Corporate Controller and Acting Principal Financial Officer | Filed Electronically |
| 32 | Section 1350 Certification | Filed Electronically |