

DIGI INTERNATIONAL INC

Form 10-Q

February 08, 2012

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

FORM 10-Q

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

For the quarterly period ended: December 31, 2011

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

41-1532464

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

11001 Bren Road East

Minnetonka, Minnesota 55343

(Address of principal executive offices) (Zip Code)

(952) 912-3444

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 January 31, 2012, there were 25,680,355 shares of the registrant's \$.01 par value Common Stock outstanding.

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

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

	Three months ended December 31,	
	2011	2010
	(in thousands, except per common share data)	
Net sales	\$ 46,662	\$ 48,334
Cost of sales (exclusive of amortization of purchased and core technology shown separately below)	21,708	22,820
Amortization of purchased and core technology	524	848
Gross profit	24,430	24,666
Operating expenses:		
Sales and marketing	10,099	9,798
Research and development	8,232	7,808
General and administrative	5,047	4,445
Restructuring	236	(50)
Total operating expenses	23,614	22,001
Operating income	816	2,665
Other income, net:		
Interest income	72	57
Interest expense		(26)
Other income (expense)	147	(12)
Total other income, net	219	19
Income before income taxes	1,035	2,684
Income tax provision	311	368
Net income	\$ 724	\$ 2,316
Net income per common share:		
Basic	\$ 0.03	\$ 0.09
Diluted	\$ 0.03	\$ 0.09

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Weighted average common shares:		
Basic	25,639	25,110
Diluted	26,143	25,445

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

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

	December 31, 2011	September 30, 2011
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 42,568	\$ 54,684
Marketable securities	54,130	51,524
Accounts receivable, net	23,920	26,433
Inventories	25,221	23,986
Deferred tax assets	2,595	2,610
Other	4,355	2,997
Total current assets	152,789	162,234
Marketable securities, long-term	9,511	1,603
Property, equipment and improvements, net	16,033	15,370
Identifiable intangible assets, net	13,199	14,360
Goodwill	85,607	86,012
Deferred tax assets	4,285	3,771
Other	519	545
Total assets	\$ 281,943	\$ 283,895
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 7,224	\$ 6,492
Accrued compensation	5,173	7,758
Accrued warranty	1,007	941
Other	4,154	4,295
Total current liabilities	17,558	19,486
Income taxes payable	2,402	2,620
Deferred tax liabilities	741	813
Other noncurrent liabilities	184	260
Total liabilities	20,885	23,179
Contingencies (see Note 10)		
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; 29,115,604 and 29,100,577 shares issued	291	291

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Additional paid-in capital	195,707	194,580
Retained earnings	103,392	102,668
Accumulated other comprehensive loss	(12,219)	(10,457)
Treasury stock, at cost, 3,438,598 and 3,471,930 shares	(26,113)	(26,366)
Total stockholders' equity	261,058	260,716
Total liabilities and stockholders' equity	\$ 281,943	\$ 283,895

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

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

	Three months ended December 31,	
	2011	2010
	(in thousands)	
Operating activities:		
Net income	\$ 724	\$ 2,316
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of property, equipment and improvements	784	713
Amortization of identifiable intangible assets	1,245	1,697
Stock-based compensation	931	871
Excess tax benefits from stock-based compensation	(13)	(59)
Deferred income tax benefit	(583)	(584)
Bad debt/product return provision	323	90
Inventory obsolescence	476	201
Restructuring	236	(50)
Other	(274)	110
Changes in operating assets and liabilities	(3,607)	(557)
Net cash provided by operating activities	242	4,748
Investing activities:		
Purchase of marketable securities	(22,789)	(2,174)
Proceeds from maturities of marketable securities	12,298	11,409
Proceeds from sale of investment	135	
Purchase of property, equipment, improvements and certain other intangible assets	(1,624)	(721)
Net cash (used in) provided by investing activities	(11,980)	8,514
Financing activities:		
Excess tax benefits from stock-based compensation	13	59
Proceeds from stock option plan transactions	150	443
Proceeds from employee stock purchase plan transactions	314	269
Net cash provided by financing activities	477	771
Effect of exchange rate changes on cash and cash equivalents	(855)	(770)
Net (decrease) increase in cash and cash equivalents	(12,116)	13,263

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Cash and cash equivalents, beginning of period	54,684	50,943
Cash and cash equivalents, end of period	\$ 42,568	\$ 64,206

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 United States Securities and Exchange Commission (the 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 (U.S. GAAP), 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 (but not limited to) the summary of significant accounting policies, presented in our Annual Report on Form 10-K for the year ended September 30, 2011 as filed with the SEC (2011 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 balance sheets 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 2011 Financial Statements, but do not include all disclosures required by U.S. GAAP.

Recently Issued Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-08, Intangibles-Goodwill and Other (Topic 350) Testing Goodwill for Impairment . This guidance provides an update on how an entity tests goodwill for impairment. This revised guidance allows companies an option to make a qualitative evaluation about the likelihood of goodwill impairment. Under the revised guidance, a company is permitted to first assess qualitative factors to determine whether goodwill impairment exists prior to performing analyses comparing the fair value of a reporting unit to its carrying amount. If, based on the qualitative assessment, a company concludes it is more likely than not that the fair value of the reporting unit exceeds its carrying value, quantitative testing for impairment is not necessary. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For us, this guidance is effective for our fiscal year beginning October 1, 2012, however early adoption is permitted. We adopted this update to be effective for our fiscal year beginning October 1, 2011. We do not expect an impact on our consolidated financial statements when we perform our goodwill testing in June 2012.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income . This guidance eliminates the option to report other comprehensive income and its components in the consolidated statement of stockholders' equity. Rather it requires that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance also requires us to present on the face of the financial statements any reclassification adjustments for items that are reclassified from other comprehensive income to net income. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. We will adopt this guidance beginning with our fiscal quarter ending December 31, 2012. The adoption of this guidance is not expected to have any effect on our consolidated financial position or results of operations, as it will only impact how certain information related to other comprehensive income is presented in our consolidated financial statements. In December 2011, FASB issued ASU No. 2011-12 which amends this guidance and defers only the presentation of reclassification of items out of accumulated comprehensive income. All other requirements in ASU No. 2011-05 are not affected by this deferral.

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 May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs . This guidance changes the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements to ensure consistency between U.S. GAAP and International Financial Reporting Standards (IFRS). This guidance is to be applied prospectively and is effective during interim and annual periods beginning after December 15, 2011. We will adopt this guidance beginning with our fiscal quarter ending March 31, 2012. We do not expect this guidance to have a material impact on our consolidated financial statements.

2. EARNINGS PER 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 our employee stock purchase plan.

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

	Three months ended December 31,	
	2011	2010
Numerator:		
Net income	\$ 724	\$ 2,316
Denominator:		
Denominator for basic net income per common share weighted average shares outstanding	25,639	25,110
Effect of dilutive securities:		
Employee stock options and employee stock purchase plan	504	335
Denominator for diluted net income per common share adjusted weighted average shares	26,143	25,445
Net income per common share, basic	\$ 0.03	\$ 0.09
Net income per common share, diluted	\$ 0.03	\$ 0.09

Because their effect would be anti-dilutive, certain potentially dilutive shares related to stock options to purchase common shares were not included in the computation of diluted earnings per common share set forth above as the options exercise prices were greater than the average market price of our common shares. There were 1,810,830 and 2,133,851 potentially dilutive shares related to such stock options for the three month periods ended December 31, 2011 and 2010, respectively.

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

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

	Three months ended December 31,	
	2011	2010
Net income	\$ 724	\$ 2,316
Other comprehensive (loss) income:		
Change in foreign currency translation adjustment	(1,783)	(2,008)
Change in net unrealized gain (loss) on investments	23	(7)
Less income tax (provision) benefit	(9)	3
Reclassification of realized loss included in net income	12	
Less income tax benefit	(5)	
Comprehensive (loss) income	\$ (1,038)	\$ 304

4. SELECTED BALANCE SHEET DATA

(in thousands)

	December 31, 2011	September 30, 2011
Accounts receivable, net:		
Accounts receivable	\$ 24,634	\$ 26,772
Less allowance for doubtful accounts	714	339
	\$ 23,920	\$ 26,433
Inventories:		
Raw materials	\$ 19,387	\$ 18,960
Work in process	471	653
Finished goods	5,363	4,373
	\$ 25,221	\$ 23,986

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

5. MARKETABLE SECURITIES

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

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

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

In order to estimate the fair value for each security in our investment portfolio, where available, we obtain quoted market prices and trading activity for each security. We also review the financial solvency of each security issuer and obtain other relevant information from our investment advisor. As of December 31, 2011, 59 of our securities were trading below our amortized cost basis. We determined each decline in value to be temporary based upon the above described factors. We expect to realize the fair value of these securities, plus accrued interest, either at the time of maturity or when the security is sold. All of our current holdings are classified as available-for-sale marketable securities and are recorded at fair value on our consolidated balance sheet with the unrealized gains and losses recorded in accumulated other comprehensive loss.

The following was the composition of our marketable securities at December 31, 2011 (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses (2)	Fair Value (1)
Current marketable securities:				
Corporate bonds	\$ 25,220	\$ 13	\$ (82)	\$ 25,151
Commercial paper	2,999		(2)	2,997
Certificates of deposit	8,765		(8)	8,757
Government municipal bonds	17,231	1	(7)	17,225
Current marketable securities	54,215	14	(99)	54,130
Non-current marketable securities:				
Corporate bonds	8,263		(34)	8,229
Certificates of deposit	250			250
Government municipal bonds	1,032			1,032
Non-current marketable securities	9,545		(34)	9,511
Total marketable securities	\$ 63,760	\$ 14	\$ (133)	\$ 63,641

(1) Included in amortized cost and fair value is purchased and accrued interest of \$699.

(2) The aggregate related fair value of securities with unrealized losses as of December 31, 2011 was \$49,464.

The following was the composition of our marketable securities at September 30, 2011 (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses (2)	Fair Value (1)
Current marketable securities:				
Corporate bonds	\$ 22,694	\$ 18	\$ (144)	\$ 22,568
Commercial paper	4,998		(3)	4,995
Certificates of deposit	8,775		(9)	8,766
Government municipal bonds	15,200	3	(8)	15,195
Current marketable securities	51,667	21	(164)	51,524
Non-current marketable securities:				
Corporate bonds	1,613		(10)	1,603
Total marketable securities	\$ 53,280	\$ 21	\$ (174)	\$ 53,127

- (1) Included in amortized cost and fair value is purchased and accrued interest of \$478.
- (2) The aggregate related fair value of securities with unrealized losses as of September 30, 2011 was \$43,755.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****6. FAIR VALUE MEASUREMENTS**

Fair value is defined as 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. This standard 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 the following three levels:

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

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

Level 3 Inputs are unobservable for the asset or liability and their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 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.

Fair value is applied to financial assets such as our marketable securities, which are classified and accounted for as available-for-sale. These items are stated at fair value at each reporting period using the above guidance. The following tables provide information by level for financial assets that are measured at fair value on a recurring basis (in thousands):

	Total carrying value at December 31, 2011	Fair Value Measurements at December 31, 2011 using:		
		Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	\$ 15,300	\$ 15,300	\$	\$
Available-for-sale marketable securities:				
Corporate bonds	33,380		33,380	
Commercial paper	2,997		2,997	
Certificates of deposit	9,007		9,007	
Government municipal bonds	18,257		18,257	
Total cash equivalents and marketable securities measured at fair value	\$ 78,941	\$ 15,300	\$ 63,641	\$

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****6. FAIR VALUE MEASUREMENTS (CONTINUED)**

	Total carrying value at September 30, 2011	Fair Value Measurements at September 30, 2011 using:		
		Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	\$ 30,474	\$ 30,474	\$	\$
Available-for-sale marketable securities:				
Corporate bonds	24,171		24,171	
Commercial paper	4,995		4,995	
Certificates of deposit	8,766		8,766	
Government municipal bonds	15,195		15,195	
Total cash equivalents and marketable securities measured at fair value	\$ 83,601	\$ 30,474	\$ 53,127	\$

Cash equivalents are measured at fair value using quoted market prices in active markets for identical assets. We value our Level 2 assets using inputs that are based on market indices of similar assets within an active market. There were no transfers in to or out of our Level 2 financial assets during the three months ended December 31, 2011.

We had no financial assets valued with Level 3 inputs as of December 31, 2011 nor did we purchase or sell any Level 3 financial assets during the three months ended December 31, 2011.

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

7. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS

Amortizable identifiable intangible assets were (in thousands):

	December 31, 2011			September 30, 2011		
	Gross carrying amount	Accum. amort.	Net	Gross carrying amount	Accum. amort.	Net
Purchased and core technology	\$ 46,296	\$ (42,138)	\$ 4,158	\$ 46,412	\$ (41,716)	\$ 4,696
License agreements	2,840	(2,628)	212	2,840	(2,610)	230
Patents and trademarks	10,475	(7,757)	2,718	10,341	(7,505)	2,836
Customer maintenance contracts	700	(691)	9	700	(674)	26
Customer relationships	17,321	(11,219)	6,102	17,437	(10,865)	6,572
Non-compete agreements	1,033	(1,033)		1,036	(1,036)	
Total	\$ 78,665	\$ (65,466)	\$ 13,199	\$ 78,766	\$ (64,406)	\$ 14,360

Amortization expense was \$1.2 million and \$1.7 million for the three month periods ended December 31, 2011 and 2010, respectively. Amortization expense is recorded on our consolidated statements of operations within cost of sales, primarily within amortization of purchased and core technology and in general and administrative expense.

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

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2012 and the five succeeding fiscal years is (in thousands):

2012 (nine months)	\$3,234
2013	3,593
2014	2,793
2015	2,132
2016	663
2017	215

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

	Three months ended December 31,	
	2011	2010
Beginning balance, October 1	\$ 86,012	\$ 86,210
Foreign currency translation adjustment	(405)	(458)
Ending balance, December 31	\$ 85,607	\$ 85,752

Goodwill is tested for impairment on an annual basis as of June 30, or more frequently if events or circumstances occur which could indicate impairment. At June 30, 2011, our market capitalization exceeded the carrying value of our reporting unit by 28.6%. As a result, there was no indication of goodwill impairment.

We have defined the criteria that will result in additional interim goodwill impairment testing. If these criteria are met, we will undertake the analysis to determine whether a goodwill impairment has occurred, which could have a material effect on our consolidated financial position and results of operations. The evaluation of asset impairment requires us to make assumptions about future cash flows and revenues. These assumptions require significant judgment and actual results may differ from assumed or estimated amounts. If these estimates and assumptions change, we may be required to recognize impairment losses in the future.

8. INCOME TAXES

Income taxes have been provided at an overall effective rate of 30.1% and 13.7% for the three month periods ended December 31, 2011 and 2010, respectively. Our effective tax rate will vary based on a variety of factors, including overall profitability, the geographical mix of income before taxes and related statutory tax rate in each jurisdiction, and discrete events, such as settlements of audits.

In the three month period ended December 31, 2011, we recorded a discrete tax benefit of \$0.1 million for the release of income tax reserves due to the expiration of the statutes of limitations from various U.S. tax jurisdictions.

In the three month period ended December 31, 2010, we recorded a discrete tax benefit of \$0.6 million primarily related to the release of income tax reserves due to the expiration of the statutes of limitations from various jurisdictions, primarily foreign. The enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided for the extension of the research and development tax credit that allowed us to record a benefit for tax credits earned during the last three quarters of fiscal 2010 in the first quarter of fiscal 2011. The aforementioned discrete income tax benefits reduced our effective tax rate for the three month period ended December 31, 2010 from 35.2 % to 13.7%.

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

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

Unrecognized tax benefits as of September 30, 2011	\$ 2,061
Decreases related to:	
Prior year income tax positions	(67)
Expiration of the statutes of limitations	(83)
Unrecognized tax benefits as of December 31, 2011	\$ 1,911

The total amount of unrecognized tax benefits that, if recognized, would affect our effective tax rate is \$1.8 million. We recognize interest and penalties related to income tax matters in income tax expense. During both the three months ended December 31, 2011 and 2010 we recognized a net benefit of \$0.1 million of interest and penalties related to uncertain tax positions in the provision for income taxes. As of December 31, 2011 and September 30, 2011, we had accrued interest and penalties related to unrecognized tax benefits of \$0.5 million and \$0.6 million, respectively, included in long-term income taxes payable on our condensed consolidated balance sheet.

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

We operate in multiple tax jurisdictions both in the U.S. and outside of the U.S. Accordingly, we must determine the appropriate allocation of income to each of these jurisdictions. This determination requires us to make several estimates and assumptions. Tax audits associated with the allocation of this income, and other complex issues, may require an extended period of time to resolve and may result in adjustments to our income tax balances in those years that are material to our consolidated financial position and results of operations. We are no longer subject to income tax examination for taxable years prior to fiscal 2009 and 2007 in the case of U.S. federal and non-U.S. income tax authorities, respectively, and for tax years generally before fiscal 2007, in the case of state taxing authorities, consisting primarily of Minnesota and California.

9. PRODUCT WARRANTY OBLIGATION

In general, we warrant our products to be free from defects in material and workmanship under normal use and service. The warranty periods generally range from one to five years. We have the option to either repair or replace products we deem defective with regard to material or workmanship. Estimated warranty costs are accrued in the period that the related revenue is recognized based upon an estimated average per unit repair or replacement cost applied to the estimated number of units under warranty. These estimates are based upon historical warranty incidents and are evaluated on an ongoing basis to ensure the adequacy of the warranty accrual.

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

Fiscal year	Balance at October 1	Three months ended December 31,		Balance at December 31
		Warranties issued	Settlements made	
2012	\$941	\$220	\$(154)	\$1,007
2011	\$877	\$118	\$(155)	\$ 840

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

9. PRODUCT WARRANTY OBLIGATION (CONTINUED)

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. Further, 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.

10. CONTINGENCIES

Contingent obligations

Initial Public Offering Securities Litigation

On April 19, 2002, a consolidated amended class action complaint was filed in the United States District Court for the Southern District of New York asserting claims relating to the initial public offering (IPO) of our subsidiary NetSilicon, Inc. and approximately 300 other public companies. We acquired NetSilicon on February 13, 2002. The complaint named us as a defendant along with NetSilicon, certain of its officers and certain underwriters involved in NetSilicon's IPO, among numerous others, and asserted, among other things, that NetSilicon's IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of NetSilicon's IPO underwriters in allocating shares in NetSilicon's IPO to the underwriters' customers. We believed that the claims against the NetSilicon defendants were without merit and we defended the litigation vigorously. Pursuant to a stipulation between the parties, the two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002.

As previously disclosed, the parties advised the District Court on February 25, 2009 that they had reached an agreement-in-principle to settle the litigation in its entirety. A stipulation of settlement was filed with the District Court on April 2, 2009. On June 9, 2009, the District Court preliminarily approved the proposed global settlement. Notice was provided to the class, and a settlement fairness hearing, at which members of the class had an opportunity to object to the proposed settlement, was held on September 10, 2009. On October 6, 2009, the District Court issued an order granting final approval to the settlement. Ten appeals were filed objecting to the definition of the settlement class and fairness of the settlement. Five of those appeals were dismissed with prejudice on October 6, 2010. On May 17, 2011, the Court of Appeals dismissed four of the remaining appeals. On January 10, 2012, the last remaining appeal was dismissed with prejudice, as a result of which the settlement became final, by its terms.

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 per claim. As of December 31, 2011, we have an accrued liability for the final settlement of \$300,000 and a receivable related to the insurance proceeds of \$50,000. This \$50,000 represents the anticipated settlement of \$300,000 less our \$250,000 deductible. We may also be reimbursed for all or part of the deductible from our insurers, which may reduce the ultimate cost to us in the future.

Patent Infringement Lawsuits

On January 18, 2011, Advanced Processor Technologies LLC filed a complaint naming us as a defendant in federal court in the Eastern District of Texas. The complaint included allegations against us and eight other companies pertaining to the infringement of two patents by products containing data processors with memory management units. On October 17, 2011, we settled the lawsuit for \$0.2 million which was recorded during the fourth quarter of fiscal 2011.

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

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

In addition to the matters discussed above, in the normal course of business, we are subject to various claims and litigation, which may include, but are not limited to, patent infringement and intellectual property claims. Our management expects that these various claims and litigation will not have a material adverse effect on our consolidated results of operations or financial condition.

11. RESTRUCTURING

On July 21, 2011, we announced a restructuring of our manufacturing operations in Breisach, Germany. The restructuring reduced our manufacturing footprint by consolidating prototype and production functions and centralizing outsourced production control in our Eden Prairie, Minnesota production facility. The consolidation was driven by our strategy of driving efficiency improvements and enhancing customer service globally through more centralized operations. We will continue to maintain sales and research and development activities at the leased facility in Breisach, Germany. As a result of these initiatives, we expect the total charge to be \$0.5 million on a pre-tax basis, which consists of \$0.4 million for employee termination costs for 25 employees and \$0.1 million for asset write-downs. We recorded a charge of \$0.2 million in the fourth quarter of fiscal 2011, \$0.2 million in the first quarter of fiscal 2012 and expect to record a charge of \$0.1 million in the second quarter of fiscal 2012. The payments are expected to be completed in the second quarter of fiscal 2012. We ceased manufacturing in Breisach at the end of December 2011 and the building continues to be occupied by sales and research and development personnel. The lease on the Breisach facility ends in July 2013.

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

	Employee Termination Costs	Other	Total
Balance at June 30, 2011	\$	\$	\$
Restructuring charge	148	76	224
Foreign currency fluctuation	(3)	(1)	(4)
Balance at September 30, 2011	145	75	220
Restructuring charge	249		249
Payments	(160)		(160)
Reversal	(13)		(13)
Foreign currency fluctuation	(17)	(4)	(21)
Balance at December 31, 2011	\$ 204	\$ 71	\$ 275

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

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, 2011, as well as our reports on Form 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 assume, believe, anticipate, intend, estimate, target, may, will, expect, plan, project, the 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. Among other items, these statements relate to expectations of the business environment in which we operate, projections of future performance, perceived marketplace opportunities and statements regarding our mission and vision. Such statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, including risks related to the highly competitive market in which our company operates, rapid changes in technologies that may displace products sold by us, declining prices of networking products, our reliance on distributors and other third parties to sell our products, delays in product development efforts, uncertainty in consumer acceptance of our products, potential liabilities that can arise if any of our products have design or manufacturing defects, our ability to defend or settle satisfactorily any litigation, uncertainty in global economic conditions which could negatively affect product demand and the financial solvency of customers and suppliers, the impact of natural disasters such as the flooding in Thailand in 2011 that has negatively impacted the manufacture of many of our products and other events beyond our control that could negatively impact our supply chain and customers, the ability to achieve the anticipated benefits and synergies associated with acquisitions, and changes in our level of revenue or profitability which can fluctuate for many reasons beyond our control. These and other risks, uncertainties and assumptions identified from time to time in our filings with the United States Securities and Exchange Commission, including without limitation, our annual report on Form 10-K for the year ended September 30, 2011 and other filings, could cause the company's future results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. Many of such factors are beyond our ability to control or predict. These forward-looking statements speak only as of the date for which they are made. We disclaim any intent or obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

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, 2011.

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

We are a leading provider of machine to machine (M2M) networking products and solutions that enable the connection, monitoring and control of local or remote physical assets by electronic means. These networking products and solutions connect communication hardware to a physical asset so that information about the asset's status and performance can be sent to a computer system and used to improve or automate one or more processes. Increasingly these products and solutions are deployed via wireless networks. Our products are deployed by a wide range of businesses and institutions. We compete for customers on the basis of existing and planned product features, service and software application capabilities, company reputation, brand recognition, technical support, relationships with partners, quality and reliability, product development capabilities, price and availability.

On October 26, 2011, we announced that the flooding in Thailand had impacted the operations of our contract manufacturer located near Bangkok, Thailand. During the first quarter of fiscal 2012, revenue decreased by approximately \$3.0 million from reduced availability of our products due to the flooding in Thailand, resulting in a reduction of earnings per diluted share of approximately \$0.05, inclusive of additional costs incurred to reestablish limited production capabilities of our contract manufacturer. We expect that the impact of the Thailand flooding for the full fiscal year 2012 will have a minimal impact on revenue and the impact to gross margin will be less than one percentage point. These expectations remain subject to change as available capacity for manufacturing at the facilities in Thailand, as well as those of other contract manufacturers, may fluctuate.

Net sales decreased from \$48.3 million in the first quarter of fiscal 2011 to \$46.7 million in the first quarter of fiscal 2012, a decrease of \$1.6 million, or 3.5%. Net sales decreased as a result of the flooding in Thailand, some economic weakness primarily in Europe, and buying patterns for a few of our larger customers. This was partially offset by an increase in demand primarily in North America. Our wireless products net sales were \$20.2 million in the first quarter of fiscal 2011 compared to \$19.8 million in the first quarter of fiscal 2012, a decrease of \$0.4 million, or 1.8%. Gross profit was \$24.4 million in the first quarter of fiscal 2012 compared to \$24.7 million in the first quarter of fiscal 2011, a decrease of \$0.3 million. We continue to employ strong cost reduction programs, which offset the \$1.9 million gross profit impact from the Thailand flooding.

Total operating expenses increased \$1.6 million for the first quarter of fiscal 2012 as compared to the same period a year ago. This primarily was due to increased headcount in the Sales, Marketing and Research and Development functions and other increased expenses in advancement of the iDigi® platform and other strategic initiatives. Total operating expenses for the first quarter of fiscal 2012 included \$0.2 million related to the restructuring for the Breisach, Germany manufacturing operations, which resulted in a workforce reduction of 25 positions.

Net income decreased from \$2.3 million, or \$0.09 per diluted share, in the first quarter of fiscal 2011 to \$0.7 million, or \$0.03 per diluted share, in the first quarter of fiscal 2012. This represented a decrease of \$1.6 million, or \$0.06 per diluted share. Net income in the first quarter of fiscal 2012 included a restructuring charge of \$0.2 million, net of taxes, or \$0.01 per diluted share. This was offset by a discrete tax benefit of \$0.1 million, or \$0.01 per diluted share, resulting from the reversal of tax reserves for closure of various jurisdictions' tax matters, and a gain on sale of an investment of \$0.1 million, net of taxes, with no earnings per diluted share impact. Net income in the first quarter of fiscal 2011 included a discrete tax benefit of \$0.6 million or \$0.02 per diluted share, which is further described in Note 8 to our Condensed Consolidated Financial Statements.

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

We anticipate that future growth will result from products and services that are developed internally as well as from products and services that are acquired. We focus a significant amount of our development, sales and marketing efforts on four vertical markets that represent significant opportunities to expand our business: energy monitoring and management, fleet vehicle tracking, medical monitoring and reporting and storage tank monitoring and control. Our suite of products and solutions primarily includes embedded and non-embedded hardware and related software solutions, wireless product design and development services and the iDigi® M2M cloud-based service.

CONSOLIDATED RESULTS OF OPERATIONS

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

	Three months ended December 31,				% increase (decrease)
	2011		2010		
Net sales	\$ 46,662	100.0%	\$ 48,334	100.0%	(3.5)%
Cost of sales (exclusive of amortization of purchased and core technology shown separately below)	21,708	46.5	22,820	47.2	(4.9)
Amortization of purchased and core technology	524	1.1	848	1.8	(38.2)
Gross profit	24,430	52.4	24,666	51.0	(1.0)
Operating expenses	23,614	50.6	22,001	45.5	7.3
Operating income	816	1.8	2,665	5.5	(69.4)
Other income, net	219	0.4	19	0.1	1052.6
Income before income taxes	1,035	2.2	2,684	5.6	(61.4)
Income tax provision	311	0.6	368	0.8	(15.5)
Net income	\$ 724	1.6%	\$ 2,316	4.8%	(68.7)%

NET SALES

Net sales decreased by \$1.6 million, or 3.5%, for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. We did not experience a material change in revenue due to pricing during the first quarter of fiscal 2012 or the first quarter of fiscal 2011.

Impact of Thailand Flooding

During the first quarter of fiscal 2012, revenue decreased by approximately \$3.0 million attributable to the flooding in Thailand. The flooding of our contract manufacturer near Bangkok primarily impacted certain products in our embedded product category, but also impacted the non-embedded product category. This flooding also had a worldwide effect on our net sales, but mostly impacted the net sales in North America.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****NET SALES (CONTINUED)***Net Sales by Non-Embedded and Embedded Product Categories*

The following summarizes our net sales by non-embedded and embedded product categories:

(\$ in thousands)	Three months ended December 31,				% increase (decrease)
	2011		2010		
Non-embedded	\$ 24,835	53.2%	\$ 27,224	56.3%	(8.8)%
Embedded	21,827	46.8	21,110	43.7	3.4
Total net sales	\$ 46,662	100.0%	\$ 48,334	100.0%	(3.5)%

Non-embedded products

Our non-embedded net sales decreased by \$2.3 million, or 8.8%, for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. The decrease was primarily driven by a decrease of \$1.7 million in net sales of cellular products primarily due to the buying patterns from a few large customers. There were also decreases of \$1.0 million in wireless communication adaptors and \$0.6 million in serial cards and USB connected devices, which was partially offset by an increase of \$1.0 million in net sales of serial servers. Sales of serial cards have been historically declining and we expect that trend to continue. We believe net sales of non-embedded products were reduced by approximately \$0.8 million due to the impact of the flooding in Thailand.

Embedded products

Our embedded net sales increased by \$0.7 million, or 3.4%, for the three months ended December 31, 2011 compared to the three months ended December 31, 2010, mostly related to increases in net sales of \$0.4 million in engineering design services and iDigi® services and an increase of \$0.3 million in net sales of modules. We believe net sales of modules were reduced by approximately \$2.2 million due to the impact of the flooding in Thailand.

Net Sales by Wireless and Wired Product Categories

The following summarizes our net sales by wireless and wired product categories:

(\$ in thousands)	Three months ended December 31,				% increase (decrease)
	2011		2010		
Wireless	\$ 19,835	42.5%	\$ 20,203	41.8%	(1.8)%
Wired	26,827	57.5	28,131	58.2	(4.6)
Total net sales	\$ 46,662	100.0%	\$ 48,334	100.0%	(3.5)%

Our wireless products comprised 42.5% of our net sales for the first quarter of fiscal 2012 and 41.8% of our net sales for the first quarter of fiscal 2011. We believe net sales of wireless products were reduced by approximately \$1.8 million due to the impact of the flooding in Thailand. As is the trend with respect to the use of telecommunications generally, we anticipate that our sales of wireless products will continue to grow proportionately faster than our sales of wired products.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****NET SALES (CONTINUED)***Net Sales by Geographic Location*

The following summarizes our total net sales by geographic region for all products:

(\$ in thousands)	Three months ended December 31,		\$ increase (decrease)	% increase (decrease)
	2011	2010		
North America	\$ 27,764	\$ 27,751	\$ 13	0.0%
EMEA	11,574	12,673	(1,099)	(8.7)
Asia countries	5,627	6,142	(515)	(8.4)
Latin America	1,697	1,768	(71)	(4.0)
Total net sales	\$ 46,662	\$ 48,334	\$ (1,672)	(3.5)%

Net sales in North America remained mostly unchanged for the three months ended December 31, 2011 compared to the same period a year ago. We believe the flooding in Thailand negatively impacted net sales in North America by approximately \$1.8 million but this impact was offset by increased net sales of products not impacted by the flooding. This flooding also had some impact on net sales in Europe, Middle East & Africa (EMEA) and Asia countries. We believe general economic weakness throughout Europe also contributed to the decrease in EMEA.

The fluctuation of foreign currency rates did not have a significant impact on net sales for the three month period ended December 31, 2011 when compared to the same period a year ago.

GROSS MARGIN

Gross margins were 52.4% and 51.0% for the three months ended December 31, 2011 and 2010, respectively. The increase in the gross margin for the three months ended December 31, 2011 as compared to the same period a year ago primarily was due to product cost reduction, manufacturing efficiencies and reduced purchased and core technology amortization as certain purchased and core technologies are now fully amortized, partially offset by an increase in inventory obsolescence expense. We do not expect that increased inventory obsolescence expense is a trend that will continue in future periods. The flooding in Thailand reduced our gross profit by approximately \$1.9 million due to lower revenue and additional costs incurred in the restoration for certain of our product lines built by our contract manufacturer located in Bangkok. For the three months ended December 31, 2011, gross margin was impacted by less than one percentage point as a result of the flooding in Thailand.

OPERATING EXPENSES

The following summarizes our total operating expenses, in dollars and as a percentage of net sales:

(\$ in thousands)	Three months ended December 31,		\$ increase (decrease)
	2011	2010	
Sales and marketing	\$ 10,099	21.7%	\$ 301
Research and development	8,232	17.6	424
General and administrative	5,047	10.8	602
Restructuring	236	0.5	286
Total operating expenses	\$ 23,614	50.6%	\$ 1,613

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

OPERATING EXPENSES (CONTINUED)

Sales and marketing expenses increased \$0.3 million for the three months ended December 31, 2011 as compared to December 31, 2010 primarily related to an increase in compensation-related expenses resulting from an increase in headcount.

Research and development expenses increased \$0.4 million for the three months ended December 31, 2011 as compared to the same period a year ago due to an increase of \$0.2 million in compensation-related expenses resulting from an increase in headcount and \$0.2 million of other research and development expenses.

General and administrative expenses increased \$0.6 million for the three months ended December 31, 2011 compared to the three months ended December 31, 2010 primarily due to an increase of \$0.5 million in bad debt expense (net of reversals in fiscal 2011) and an increase of \$0.3 million in compensation-related expenses. These increases were partially offset by a decrease of \$0.2 million in other general and administrative expenses.

We recorded restructuring expenses of \$0.2 million in the first quarter of fiscal 2012 resulting from the restructuring of our Breisach, Germany operations which was announced on July 21, 2011. During the first quarter of fiscal 2011 we reversed \$0.1 million of restructuring expenses relating to our Davis, California restructuring announced in April 2009.

OTHER INCOME, NET

Other income, net increased by \$0.2 million for the three months ended December 31, 2011 compared to the three months ended December 31, 2010, primarily related to the sale of an investment of \$0.1 million and a slight increase in foreign currency net gains. Net interest income increased slightly for the three month periods ended December 31, 2011 compared to the same period in the prior year.

INCOME TAXES

In the three month period ended December 31, 2011, we recorded a discrete tax benefit of \$0.1 million for the release of income tax reserves due to the expiration of the statutes of limitations from various U.S. tax jurisdictions.

In the three month period ended December 31, 2010, we recorded a discrete tax benefit of \$0.6 million primarily related to the release of income tax reserves due to the expiration of the statutes of limitations from various jurisdictions, primarily foreign. The enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided for the extension of the research and development tax credit that allowed us to record a benefit for tax credits earned during the last three quarters of fiscal 2010 in the first quarter of fiscal 2011. The aforementioned discrete income tax benefits reduced our effective tax rate for the three month period ended December 31, 2010 from 35.2 % to 13.7%.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations principally with funds generated from operations. At December 31, 2011, we had cash, cash equivalents and short-term marketable securities of \$96.7 million compared to \$106.2 million at September 30, 2011. Our working capital (total current assets less total current liabilities) decreased \$7.5 million to \$135.2 million at December 31, 2011 compared to \$142.7 million at September 30, 2011. Both the decrease in cash, cash equivalents and short-term marketable securities and the decrease in working capital at December 31, 2011 compared to September 30, 2011 were primarily due to additional purchases of marketable securities in the first quarter of fiscal 2012 that are long-term. We anticipate total fiscal 2012 capital expenditures will be approximately \$4.3 million.

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

LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)

Net cash provided by operating activities was \$0.2 million for the three months ended December 31, 2011 as compared to \$4.7 million for the three months ended December 31, 2010, a net decrease of \$4.5 million. This decrease primarily was due to a decrease in net income of \$1.6 million and a working capital net decrease of \$3.1 million. The net decrease of \$3.1 million in working capital was related to a decrease in accrued liabilities as we had a full bonus payout in first quarter of fiscal 2012 as compared to a partial bonus payout in first quarter of fiscal 2011. There also were other decreases related to accounts payable and inventory partially due to additional inventory purchases we needed to make because of the flooding in Thailand. This was offset partially by a reduction in accounts receivable balances in the three months ended December 31, 2011 compared to the same quarter a year ago.

Net cash used in investing activities was \$12.0 million during the three months ended December 31, 2011 as compared to net cash provided by investing activities of \$8.5 million during the three months ended December 31, 2010. During the first quarter of fiscal 2012 as compared to the same quarter a year ago, we used an additional \$19.7 million for net purchases of marketable securities. We also used an additional \$0.8 million in net capital expenditures partially due to acceleration of purchases in conjunction with the Thailand flooding.

Cash provided by financing activities was \$0.5 million and \$0.8 million during the three months ended December 31, 2011 and 2010, respectively, a net decrease of \$0.3 million. We received \$0.3 million less in proceeds from employee stock option transactions during the first three months of fiscal 2012 as compared to the same period a year ago.

We believe that our current cash, cash equivalents and marketable securities balances, cash generated from operations and our ability to secure debt and/or equity financing will be sufficient to fund our business operations for the next twelve months and beyond. We believe that our cash equivalents and short-term marketable securities are liquid and accessible. The objectives of our investment policy are the preservation of principal and maintenance of liquidity. We intend to maintain a highly liquid portfolio by investing only in those marketable securities that we believe have active secondary or resale markets.

As of December 31, 2011, there were no material changes to our contractual obligations as disclosed in our Annual Report on Form 10-K for the year ended September 30, 2011.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-08, Intangibles-Goodwill and Other (Topic 350) Testing Goodwill for Impairment . This guidance provides an update on how an entity tests goodwill for impairment. This revised guidance allows companies an option to make a qualitative evaluation about the likelihood of goodwill impairment. Under the revised guidance, a company is permitted to first assess qualitative factors to determine whether goodwill impairment exists prior to performing analyses comparing the fair value of a reporting unit to its carrying amount. If, based on the qualitative assessment, a company concludes it is more likely than not that the fair value of the reporting unit exceeds its carrying value, quantitative testing for impairment is not necessary. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For us, this guidance is effective for our fiscal year beginning October 1, 2012, however early adoption is permitted. We adopted this update to be effective for our fiscal year beginning October 1, 2011. We do not expect an impact on our consolidated financial statements when we perform our goodwill testing in June 2012.

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

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS (CONTINUED)

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. This guidance eliminates the option to report other comprehensive income and its components in the consolidated statement of stockholders' equity. Rather it requires that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance also requires us to present on the face of the financial statements any reclassification adjustments for items that are reclassified from other comprehensive income to net income. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. We will adopt this guidance beginning with our fiscal quarter ending December 31, 2012. The adoption of this guidance is not expected to have any effect on our consolidated financial position or results of operations, as it will only impact how certain information related to other comprehensive income is presented in our consolidated financial statements. In December 2011, FASB issued ASU No. 2011-12 which amends this guidance and defers only the presentation of reclassification of items out of accumulated comprehensive income. All other requirements in ASU No. 2011-05 are not affected by this deferral.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This guidance changes the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements to ensure consistency between U.S. GAAP and International Financial Reporting Standards (IFRS). This guidance is to be applied prospectively and is effective during interim and annual periods beginning after December 15, 2011. We will adopt this guidance beginning with our fiscal quarter ending March 31, 2012. We do not expect this guidance to have a material impact on our consolidated financial statements.

Table of Contents**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, commercial paper, corporate bonds and government municipal 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. We do not use derivative financial instruments to hedge against interest rate risk because the majority of our investments mature in less than a year.

FOREIGN CURRENCY RISK

We have transactions that are executed in the U.S. Dollar, British Pound, Euro, Japanese Yen and Indian Rupee. As a result, we are exposed to foreign currency transaction risk associated with certain sales transactions being denominated in Euros, British Pounds, Japanese Yen or Indian Rupees, and foreign currency translation risk as the financial position and operating results of our foreign subsidiaries are translated into U.S. Dollars for consolidation. We have not implemented a formal hedging strategy although we employ natural hedging of assets and liabilities denominated in foreign currencies to reduce foreign currency risk.

For the three months ended December 31, 2011 and 2010, we had approximately \$18.9 million and \$20.6 million, respectively, of net sales to foreign customers including export sales. Of these sales, \$6.0 million and \$7.4 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, Japanese Yen and Indian Rupee to the U.S. Dollar:

	Three months ended December		% increase (decrease)
	2011	31, 2010	
Euro	1.3486	1.3600	(0.8)%
British Pound	1.5719	1.5815	(0.6)%
Japanese Yen	0.0129	0.0121	6.9%
Indian Rupee	0.0195	0.0222	(12.0)%

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

A 10% change in the first three months of fiscal year 2012 average exchange rate for the Euro, British Pound, Japanese Yen and Indian Rupee to the U.S. Dollar would have resulted in a 1.3% increase or decrease in net sales and a 1.8% increase or decrease in stockholders' equity due to foreign currency translation. The above analysis does not take into consideration any pricing adjustments we might consider in response to changes in such exchange rates.

CREDIT RISK

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

Investments are made in accordance with our investment policy and consist of certificates of deposit, commercial paper, money market funds, government municipal bonds and corporate bonds. We may have some credit exposure related to the fair value of our securities, which could change based on changes in market conditions. If market conditions deteriorate 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 SEC rules and forms and is accumulated and communicated to our management, including the principal executive and principal financial officers, 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.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

There have been no material changes in the risk factors previously disclosed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended September 30, 2011.

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

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

None

ITEM 5. OTHER INFORMATION

None

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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 Chief Financial Officer
32	Section 1350 Certification
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

- (1) Incorporated by reference to Exhibit 3(a) to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972)
- (2) Incorporated by reference to Exhibit 3 to the Company's Current Report on Form 8-K filed January 21, 2011 (File No. 1-34033)
- (3) Incorporated by reference to Exhibit 4(a) to the Company's Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)
- (4) Incorporated by reference to Exhibit 4(b) to the Company's Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

DIGI INTERNATIONAL INC.

Date: February 8, 2012

By: /s/ Steven E. Snyder
Steven E. Snyder
Senior Vice President, Chief Financial
Officer and Treasurer (Principal
Accounting Officer)

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EXHIBIT INDEX

Exhibit Number	Document Description	Form of Filing
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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 Chief Financial Officer	Filed Electronically
32	Section 1350 Certification	Filed Electronically
101.INS	XBRL Instance Document	Filed Electronically
101.SCH	XBRL Taxonomy Extension Schema Document	Filed Electronically
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	Filed Electronically
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	Filed Electronically
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	Filed Electronically
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	Filed Electronically