

DIGI INTERNATIONAL INC

Form 10-K

December 05, 2008

**Table of Contents**

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

**FORM 10-K**

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

**For the fiscal year ended: September 30, 2008**

**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)

**Securities registered pursuant to Section 12(b) of the Act:**

**Title of each class**

**Name of each exchange on which registered**

Common Stock, par value \$.01 per share

The NASDAQ Global Select Market

**Securities registered pursuant to Section 12(g) of the Act:**

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the  
Act. Yes  No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of  
the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing  
requirements for the past 90 days.

Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained  
herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements  
incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Edgar Filing: DIGI INTERNATIONAL INC - Form 10-K

company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a 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   
The aggregate market value of voting stock held by non-affiliates of the Registrant as of the last business day of the Registrant's most recently completed second fiscal quarter was \$296,263,339 based on a closing price of \$11.54 per common share as reported on the NASDAQ Global Select Market (formerly the NASDAQ National Market).  
Shares of common stock outstanding as of November 28, 2008: 25,383,253

---

**Table of Contents****INDEX**

## DOCUMENTS INCORPORATED BY REFERENCE

The following table shows, except as otherwise noted, the location of information required in this Form 10-K, in our Annual Report to Stockholders for the year ended September 30, 2008 and Proxy Statement for our Annual Meeting of Stockholders scheduled for January 26, 2009, a definitive copy of which will be filed on or about December 5, 2008. All such information set forth below under the heading Page/Reference is incorporated herein by reference, or included in this Form 10-K on the pages indicated.

|                        | ITEM IN FORM 10-K   | PAGE/REFERENCE |
|------------------------|---|----------------|
| <b><u>PART I.</u></b>  |   |                |
| <u>ITEM 1.</u>         | <u>Business</u>   | 4              |
| <u>ITEM 1A.</u>        | <u>Risk Factors</u>   | 14             |
| <u>ITEM 1B.</u>        | <u>Unresolved Staff Comments</u>  | 21             |
| <u>ITEM 2.</u>         | <u>Properties</u>   | 22             |
| <u>ITEM 3.</u>         | <u>Legal Proceedings</u>  | 23             |
| <u>ITEM 4.</u>         | <u>Submission of Matters to a Vote of Security Holders</u>  | 24             |
| <b><u>PART II.</u></b> |   |                |
| <u>ITEM 5.</u>         | <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | 25             |
| <u>ITEM 6.</u>         | <u>Selected Financial Data</u>  | 27             |
| <u>ITEM 7.</u>         | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                        | 28             |
| <u>ITEM 7A.</u>        | <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | 45             |
| <u>ITEM 8.</u>         | <u>Financial Statements and Supplementary Data</u>  | 46             |
| <u>ITEM 9.</u>         | <u>Changes in and Disagreements with Accountants On Accounting and Financial Disclosure</u>                         | 80             |
| <u>ITEM 9A.</u>        | <u>Controls and Procedures</u>  | 80             |
| <u>ITEM 9B.</u>        | <u>Other Information</u>  | 80             |

**Table of Contents**

| ITEM IN FORM 10-K                                 | PAGE/REFERENCE  |
|---|---|
| <b><u>PART III.</u></b>                           |   |
| <b><u>ITEM 10.</u></b>                            | <b><u>Directors, Executive Officers and Corporate Governance</u></b>  |
| Directors of the Registrant                       | Election of Directors, Proxy Statement  |
| <u>Executive Officers of the Registrant</u>       | 81  |
| Compliance with Section 16(a) of the Exchange Act | Section 16(a) Beneficial Ownership Reporting Compliance, Proxy Statement  |
| Code of Ethics                                    | 82  |
| Audit Committee                                   | Proxy Statement   |
| <b>ITEM 11.</b>                                   | <b>Executive Compensation</b>   |
|   | Election of Directors Compensation Committee Interlocks and Insider Participation; Executive Compensation, Compensation of Directors, Proxy Statement |
| <b><u>ITEM 12.</u></b>                            | <b><u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u></b>  |
|   | Security Ownership of Principal Stockholders and Management, Proxy Statement  |
|   | <u>Equity Compensation Plan Information</u> <span style="float: right;">82</span>   |
| <b>ITEM 13.</b>                                   | <b>Certain Relationships and Related Transactions, Director Independence</b>  |
|   | Election of Directors Director Independence; Related Person Transaction Approval Policy, Proxy Statement  |
| <b>ITEM 14.</b>                                   | <b>Principal Accounting Fees and Services</b>   |
|   | Audit and Non-Audit Fees, Proxy Statement   |
| <b><u>PART IV.</u></b>                            |   |
| <b><u>ITEM 15.</u></b>                            | <b><u>Exhibits, Financial Statement Schedules</u></b> <span style="float: right;">85</span>   |
| <u>EX-10.(o)</u>                                  |   |
| <u>EX-22</u>                                      |   |
| <u>EX-23</u>                                      |   |
| <u>EX-24</u>                                      |   |
| <u>EX-31.(a)</u>                                  |   |
| <u>EX-31.(b)</u>                                  |   |
| <u>EX-32</u>                                      |   |



**Table of Contents**

**PART I**

**FORWARD-LOOKING STATEMENTS**

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

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

Our future operating results and performance trends may be affected by a number of factors, including, without limitation, those described in Item 1A, Risk Factors, of this Form 10-K. 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.

**ITEM 1. BUSINESS**

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.

**COMPANY OVERVIEW**

Digi International Inc. was formed in 1985 as a Minnesota corporation and reorganized as a Delaware corporation in 1989 in conjunction with its initial public offering. Our common stock is traded on the NASDAQ Global Select Market under the symbol DGII. With our global headquarters in Minnetonka, Minnesota, regional sales offices throughout North America, Europe, Japan and Asia Pacific our products are available through approximately 295 distributors in more than 74 countries. We also have engineering locations in North America and Europe.

Our first products (sold under the DigiBoard® brand) were box and board-level serial port adapters that were used to directly connect multiple peripherals, such as standalone computer terminals, to personal computers or a host computer system. During the 1990 s, Ethernet became the connectivity infrastructure for businesses and over time it has been extended into factories, retail stores, restaurants, hospitals and many other environments. During the same period, the semiconductor industry was also in a phase of rapid advancement. Complete systems were being built on a single integrated circuit (chip). As part of a box or board level product, these chips could be used to build a network interface for virtually any device for which network connectivity was required. Recognizing the developing opportunities for device connectivity, we implemented a strategy in early 2000 to leverage the brand strength that we had established with the DigiBoard product line by organically developing or acquiring next-generation connectivity products and technologies that would extend the value of the Digi brand into an array of device networking applications.

**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**COMPANY OVERVIEW (CONTINUED)**

During the course of the past several years, we have augmented our strategy with an increasing emphasis on developing wireless device connectivity solutions. In fiscal 2007, we launched our Drop-in Networking initiative which provides end-to-end wireless access to electronic devices in places where wires will not work or cannot be used. Our Drop-in Networking family of products includes modules, wireless communications adapters, cellular routers, gateways, sensors and network management software. For applications in energy management, building control, manufacturing, supply chain management, logistics, telematics and many others, Drop-in Networking products provide a non-intrusive way to connect devices anywhere they reside. Devices are being connected that were previously not networked, such as irrigation controls for farms and golf courses, fish farm monitoring equipment and fitness equipment to name a few. Our Drop-in Networking solutions are also used in many green applications such as monitoring and controlling energy usage, monitoring new forms of energy production such as wind and solar, conserving water resources, and insuring trucks only go out to refill chemical tanks when needed. Drop-in Networking enables our customers to differentiate their products, provide better customer service and frequently create new revenue streams.

Our Drop-in Networking initiative provides opportunities for us in the next wave of Internet growth. The initial wave was focused on connecting people, first with personal computers and now with cell phones, PDA's and other related consumer devices. This next wave is about connecting devices and machines. We believe that the Internet will support billions of new devices in the next several years. We are ideally positioned to take full advantage of the second wave of Internet growth with our Drop-in Networking Solutions that will provide significant market expansion in what is now being referred to in the market as wireless machine to machine (M2M) connectivity.

M2M communication works by connecting communication hardware to a physical asset so that information about its status and performance can be sent to a computer system and used to automate a business process or a human action so that a person does not have to do it manually. We were named a pioneer in M2M technology by M2M Magazine and are now enabling customers to do this wirelessly. Our Drop-in Networking solution is making it easy for customers to effectively drop-in a wireless M2M solution incorporating products from both our embedded and non-embedded products.

**PRODUCTS**

Our products are divided into two categories: embedded and non-embedded. An embedded product is incorporated by a product developer into an electronic device (e.g., utilities meter, environmental sensors, retail scanner, medical instrument). It provides processing power and wired or wireless network connectivity to that device. Additional hardware and/or software development is required on the part of the customer when using an embedded product as the product usually is an integrated internal part of the device.

A non-embedded product is connected externally to a device or larger system (e.g., retail checkout, building access control panel, traffic controller) to provide network connectivity or port expansion. Non-embedded products generally do not require additional hardware development and can often be used right out of the box, although they do provide an environment for adding custom software as well. These products provide an economical way to network-enable previously deployed devices, allowing companies to utilize the latest technologies without the cost of replacing existing equipment.



**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**PRODUCTS (CONTINUED)**

**Embedded Networking Products**

**Modules** Developing a device around a chip or microprocessor involves a high level of complexity. A module is a group of components that are set up to work together, eliminating much of that complexity. An embedded module may provide somewhat less flexibility than a chip, but is much easier to implement into a product design.

Our modules can be divided into two categories: processor modules and communications modules. Processor modules provide customers with a networked platform for use as the main processor in an embedded system and the flexibility to add in custom features and functionality, as this ensures a very quick time to market development cycle for a network-enabled device. These modules are targeted as the core processors for products such as access control systems, Point-of-Sale (POS) systems, Radio Frequency ID (RFID) readers, medical devices and instrumentation and networked displays. Communication modules are ideal for network-enabling and web-enabling a device. They enable customers who wish to easily accommodate both wired and wireless functionality in one product design. Typically with a communication module, there is another processor performing the central processing. Adding wired or wireless network communication to a device allows companies to manage that device over a network or via the Internet.

**Chips** A chip (or microprocessor) provides the brains and processing power of an intelligent electronic device or communication sub-system. Some of our higher volume customers choose to purchase chips and build their own products. Chips are low cost but require the highest level of development expertise. Building a solution from the chip level offers a low cost of the end design, but the level of complexity in product development can increase risk and prolong time to market.

Our chips are the building blocks for many of our embedded and non-embedded products. By using our own microprocessors we can ensure complete hardware/software compatibility for product designs. In addition this allows us to guarantee long-term availability to our module customers. This is a significant advantage since many of these products are expected to be in use for five to ten years once they are developed.

**Software and Development Tools** Single-board computers (SBCs) are complete systems on a single circuit board. They are essentially a programmable box product without the enclosure everything is on the board and ready to be embedded into a larger system. They offer the same benefits as the processor modules, but eliminate the need for additional interface circuitry because they include all of the key device interface components on one circuit board.

**Network Interface Cards** Our intelligent Network Interface Cards (NICs) are legacy products that were used to provide Ethernet networking interfaces for printers. This function has been increasingly taken over by the main processor.

**Services** With the recent acquisition of Spectrum Design Solutions Inc. (Spectrum), we now offer engineering design services to customers that are challenged with their wireless development projects. Our specialized engineers have extensive experience in wireless technologies such as Global System for Mobile communication (GSM), Code Division Multiple Access (CDMA), Global Positioning System (GPS), Wi-Fi and proprietary RF as well as Application Specific Integrated Circuit (ASIC) design, Field Programmable Gate Array (FPGA) integration, embedded software and complete turn-key product development which allows them to address virtually any wireless development need.

**Table of Contents****ITEM 1. BUSINESS (CONTINUED)****PRODUCTS (CONTINUED)****Non-Embedded Products**

**Cellular Routers** Cellular routers provide connectivity for devices over a cellular data network. They can be used as a cost effective alternative to landlines for primary or backup connectivity for hard to reach sites and devices. We introduced the first intelligent high-speed cellular router in 2005 to address the growing need for customers to connect remote sites and devices. These products have been certified by the major wireless providers in the U.S. and abroad, including AT&T®, Verizon Wireless® and Sprint®. All of our cellular products include a unique management platform called Digi Connectware® that provides a secure management of devices across remote networks.

**Gateways** A gateway aggregates local wireless data traffic and transports it over a cellular or other Internet Protocol (IP)-based network, usually back to a central application or database. Our gateway products, part of our Drop-in Networking solution, enable devices or groups of devices to be networked in locations where there is no existing network or where access to a network is prohibited. These gateways can work in conjunction with our wireless adapters and wireless embedded modules to enable customers to monitor and manage remote devices in a non-intrusive and economical way. Like our Cellular routers, all of our gateway products include a unique network management software platform called Digi Connectware® that provides secure management of devices across remote networks.

**Wireless Communication Adapters** Our wireless communication adapters are small box products that utilize a variety of wireless protocols for PC-to-device or device-to-device connectivity, often in locations where deploying a wired network is not possible either because of cost, disruption or impracticality. By supporting ZigBee®, Wi-Fi® and proprietary radio frequency (RF) technologies, we can meet most customer application requirements, such as serial cable replacement, Ethernet cable replacement, mesh networking, low cost/low power remote monitoring, simple I/O control functions, environmental sensors and long distance connectivity.

**Console Servers** Console servers, or console management servers, provide access to the serial ports of network equipment such as servers, routers or switches. Our intelligent console servers enable customers to access, monitor or manage their network devices across multiple sites, both remotely over the network or via their console ports even during network outages. These console servers provide advanced auditing and logging capabilities that complement regulatory compliance efforts such as Sarbanes-Oxley and HIPPA.

**Serial Servers** Serial Servers (also known as device servers and terminal servers) add wired or wireless network connectivity to a serial device. They transfer data between a serial port and an Ethernet network, turning a previously isolated device with a serial port into a fully collaborative network component. Our belief is that serial servers will remain an important product category as Ethernet based serial connections continue to extend beyond their current applications into many new markets such as building automation, healthcare, process control, and secure console port management on servers, routers, switches and other network equipment.

**USB Connected Products** The Universal Serial Bus (USB) is a plug-and-play interface between a computer and peripheral devices. In recent years, many serial ports on PCs have been replaced with USB ports, due in large part to the usability and cost effectiveness of USB devices. We have one of the most comprehensive and advanced USB port expansion product lines in the industry. Our USB-to-serial converters enable customers to expand a single USB port into multiple serial ports to connect legacy peripheral devices. The product line also includes USB hubs that add additional USB or powered USB ports, which are often used in retail environments; and a network-enabled hub that connects USB devices over an IP network, which is an industry first.

**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**PRODUCTS (CONTINUED)**

**Remote Display Products** Our remote display connectivity solutions are designed for digital advertising, digital menus, airport status displays, stadium scoreboards, or other applications where visual content is to be displayed in public areas. These zero-clients connect display, serial and USB devices over an IP-based network, without a dedicated PC or thin client. Removing the PC or thin client in a digital display solution not only saves space but reduces costs and increases security and reliability.

**Cameras and Sensors** Cameras and sensors are used in a wide variety of environmental monitoring and building automation/security applications. Our cameras and sensors are supported by application software that provides device status, data logging and alerts. These products also play a role in our Drop-in Network portfolio of products. The cameras can be connected to our cellular routers and gateways to provide video or still-frame images from select locations. The sensors are standalone wireless or can also be connected to our wireless adapters to provide environmental data from end-point nodes.

**Serial Cards** A serial card plugs into the expansion slot of a computer to provide serial ports for device connectivity. We are a global leader in this category and offer one of the most extensive serial card product families. Our products support a wide range of operating systems, port densities, bus types, expansion options and applications. As Ethernet connections extend beyond current applications, the serial card products are gradually transitioning to network-attached and/or USB- attached devices. We have strengthened our product offering to meet customer needs and fully support this mature product line while working to seamlessly transition customers to newer technologies.

**Network Management Software** Network management software provides a means of managing devices on a network from remote locations. We offer network management software that provides enterprise class management and administration for many of our products, including gateways, cellular routers, adapters and embedded communication modules. It enables customers to securely manage, monitor, configure and control groups of devices remotely across a wired or wireless IP-based network, including cellular networks, local area networks and the broader Internet. One of the key benefits of this software is the reduction of administrative maintenance costs, which requires fewer trips to remote locations because the software can be used to diagnose and solve problems. In addition, this software also enables a web services based communication connection to all devices, a key component of a Drop-in Networking solution.

**APPLICATION MARKETS**

We believe we are a worldwide leader in commercial device connectivity, through network-enabling devices in stores, factories, office buildings, banks, gas stations, oil rigs, hospitals, and many other vertical environments.

**Industrial Automation** We provide products to network-enable process and quality control equipment, pump controllers, bar-code readers/scanners, scales and weighing stations, printers, machine vision systems, programmable logic controllers (PLCs) and many other types of manufacturing equipment. Connecting these devices over a network can help a manufacturing facility solve problems associated with productivity, inventory management and quality control.

**Retail/Point-of-Sale (POS)** Our products solve the challenges associated with enabling POS devices to effectively share information across the network. They can be used to easily connect network devices like card swipe readers, bar-code scanners, scales, receipt printers and cash register display poles.

**Building Automation/Security** Our products help automate and control buildings heating, ventilation and air conditioning (HVAC) and security systems, and solve the problem of standalone control systems that are unable to communicate with each other and share important data. Our solutions can be used to centrally manage equipment and improve the comfort, safety and productivity of building occupants.

**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**APPLICATION MARKETS (CONTINUED)**

**Medical/Healthcare** We provide a way to network-enable medical equipment and devices to receive, monitor and access patient information quickly, easily, and accurately, utilizing the hospital's existing Ethernet or wireless network to improve patient care and reduce operating costs.

**Utilities** Migrating to IP-based network communications can be a challenge for utility companies, due to compatibility issues between field equipment and the applications used with them. Our products enable companies to network-enable existing products in the field without replacing hardware or rewriting existing application software and are used in Automated Meter Reading (AMR), Automated Meter Intelligence (AMI) and other smart energy applications.

**Data Center Management** Our out-of-band management solutions enable immediate response when a network fails or in other critical situations, providing connectivity to servers and network equipment when the primary network is down and eliminating costly travel to remote sites.

**Office Networking** Each business day billions of images are created, moved and then output in some form over networks and the Internet in a process called image communication. This demanding process has driven the need for a new generation of network attached devices to manage the ever increasing load of network media. We provide core solutions for connecting, enabling and managing this process for office, industrial and POS printers, as well as multifunction peripherals (MFPs), network cameras, network liquid crystal displays (LCDs), information displays and network projectors.

**Traffic Management** Our solutions make it easy to Ethernet-enable the field devices along roadsides and at intersections so that a traffic management center has access to real-time information. Some of the functions enabled by these solutions include traffic light coordination, hazardous road condition alerts and variable message sign updates.

**Remote Device Management** We provide hardware and software solutions that utilize remote cellular networks like GSM, General Packet Radio Service (GPRS)/Enhanced Data rate for Global Evolution (EDGE) to manage, monitor and control assets in geographically distributed locations.

**Hazardous Environments** We safely and reliably connect devices in harsh, volatile locations.

**Digital Signage** Our technology makes it easy to update content on scoreboards, billboards and other electronic displays.

**Government** We provide needs assessment, technical assistance, and ongoing engineering support for government projects.

**ACQUISITIONS**

We have made several acquisitions in the past four fiscal years that are consistent with our corporate strategy.

In April 2005, we acquired FS Forth-Systeme GmbH/Sistemas Embebidos S.A. (FS Forth), leading providers of embedded modules based on our processors and NET+OS software, as well as other microprocessors with supporting embedded software. The acquisition enhanced our embedded module portfolio and also added expertise in a wide range of popular operating systems including Linux and Microsoft Windows CE. Effective October 1, 2006, FS Forth merged into Digi International GmbH.

**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**ACQUISITIONS (CONTINUED)**

In May 2005, we acquired Rabbit Semiconductor® Inc. (formerly Z-World, Inc.). The acquisition expanded our embedded portfolio to include the Rabbit line of microprocessors and microprocessor-based core modules and Z-World single-board computers (now all sold under the Rabbit brand). With bundled hardware and software, these products facilitate quick time-to-market for device manufacturers who need to add network connectivity to endpoint devices such as sensors, meters, vending machines, card readers, and scales. Effective October 1, 2007, Rabbit Semiconductor® Inc. merged into Digi International Inc.

In July 2006, we acquired MaxStream®, Inc. (MaxStream), a leader in the wireless device networking market. MaxStream supplies device manufacturers and integrators with reliable wireless modules and box products that are easy to use and allow customers to wirelessly monitor and control electronic devices. Typical applications include automated utility meter reading, oil and gas monitoring, remote control and monitoring of commercial heating and air conditioning systems, vehicle information access for fleet management, industrial controls, wireless sensors, and electronic signals. MaxStream was also a pioneer in the field of ZigBee®/802.15.4 wireless communications. The MaxStream acquisition significantly expanded our wireless offering both with embedded modules and non-embedded wireless communications adapters. The products also play a key role in our Drop-in Networking initiative. Effective October 1, 2007, MaxStream merged into Digi International Inc.

In April 2008, we acquired Sarian Systems, Ltd. (Sarian), a leader in the European wireless router market. Sarian designs, develops and manufactures advanced wireless/cellular IP-based routing equipment for mission critical applications. Sarian developed its own comprehensive IP-based operating system and software and can offer customers technical excellence, flexibility and rapid customization. Sarian has a strong customer base in ATM connectivity, retail and payment systems connectivity, remote monitoring telemetry, lottery terminal connectivity and wireless backup of wired broadband connections.

In July 2008, we acquired Spectrum Design Solutions, Inc. (Spectrum), a leading design services organization. Spectrum focuses on solving a customer's wireless development challenges. Spectrum's engineers have extensive experience in wireless technologies such as GSM, CDMA, GPS, Wi-Fi and proprietary RF as well as ASIC design, FPGA integration, embedded software and complete turn-key product development which allows them to address virtually any wireless development need.

Our products are sold under the Digi, Rabbit and Sarian brands. The Digi, Rabbit and Sarian brands have established strong identities with our targeted customer base. Our customers associate the Digi and Sarian brands with reliability and the Rabbit brand with ease of integration. Many of our customers choose us because they are building a very complex system solution and they want the highest level in product reliability. In the core module and semiconductor application environments, ease of integration is a powerful brand identity.

We continue to leverage a common core technology base to develop and provide innovative connectivity solutions to our customers. Core technology is used across product lines to provide additional functionality for customers, allowing them to get to market with network-enabled devices faster. We have positioned ourselves in the growing market of integrated hardware and software connectivity solutions to network-enable the coming generation of intelligent devices in business applications.

**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**DISTRIBUTION AND PARTNERSHIPS**

We sell our products through a global network of distributors, systems integrators, value added resellers (VARs) and original equipment manufacturers (OEMs).

Our larger U.S. distributors include Tech Data Corporation, Arrow Distributing, Ingram Micro, Synnex, Future Electronics and NuHorizons. We also maintain relationships with many other distributors in the U.S., Canada, Europe, Asia Pacific, and Latin America. Additionally, we maintain strong relationships with catalog distributors CDW, Insight, Digi-Key and Mouser Electronics.

We maintain strategic alliances with other industry leaders to develop and market technology solutions. These include most major communications hardware and software vendors, operating system suppliers, computer hardware manufacturers, and cellular carriers. Key partners include: Microsoft, VMware, Hewlett Packard, IBM, Dell, Toshiba, Atmel, Ember, Freescale, Qualcomm, Wavecom, AT&T, Sprint, Verizon, Rogers and several other cellular carriers worldwide. Furthermore, we maintain a worldwide network of authorized developers that extends our reach into certain other technology applications and geographical regions.

Our customer base includes many of the world's largest companies. We have strategic sales relationships with leading vendors, allowing them to ship our board and network products as component parts of their overall networking solutions. These vendors include IBM, Rackable, NCR, Sun Microsystems, Fujitsu Transaction Solutions, Air Products, Nalco, TXU Energy and Hewlett Packard, among others. Many of the world's leading telecommunications companies and Internet service providers also rely on our products, including Alcatel-Lucent, AT&T, Sprint, Verizon and Siemens.

No customer comprised more than 10% of our net sales for the years ended September 30, 2008, 2007 and 2006.

We compete 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, company reputation, brand recognition, technical support, relationships with partners, quality and reliability, product development capabilities, price and availability. While we have no competitors that carry a comparable range of products, we do have various competitors based on specific products.

We are a leader in device networking for business, developing reliable products and technologies to connect and securely manage local or remote electronic devices over the network or via the Internet. Our enterprise solutions include embedded or non-embedded products or combinations of these products.

**OPERATIONS**

Our operations are completed through a combination of internal manufacturing and hiring of subcontracted assembly to outside firms that specialize in such services. We rely on third party foundries for our semiconductor devices (ASICs). This approach is beneficial because it allows us to reduce our fixed costs, maintain production flexibility and optimize our profits.

Our products are manufactured to our designs with standard and semi-custom components. Most of these components are available from multiple vendors. We have several single-sourced supplier relationships, either because alternative sources are not available or because the relationship is advantageous to us. If these suppliers are unable to provide a timely and reliable supply of components, we could experience manufacturing delays that could adversely affect our consolidated results of operations.

**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**OPERATIONS (CONTINUED)**

**SEASONALITY**

In general, our business is not considered to be highly seasonal, although our first fiscal quarter revenue is often less than other quarters due to the holidays and fewer shipping days. In addition, some of our products are dependent upon the semiconductor industry which is highly cyclical and subject to rapid technological change.

**RESEARCH AND DEVELOPMENT**

During fiscal years 2008, 2007 and 2006, our research and development expenditures were \$27.1 million, \$24.2 million and \$20.9 million, respectively. Due to rapidly changing technology in the communications technology industry, we believe that our success depends primarily upon the product development skills of our personnel, and the ability to integrate acquired technologies with organically developed technologies. We may incur in-process research and development charges in connection with our acquisitions, which are expensed upon consummation of the acquisitions. Acquired in-process research and development charges are disclosed separately and are incremental to the research and development expenditures disclosed above. Our proprietary rights and technology are protected by a combination of copyrights, trademarks, trade secrets and patents. We have established common law and registered trademark rights on a family of marks for a number of our products.

**BACKLOG**

As of September 30, 2008, we had backlog orders in the amount of \$29.2 million. Most of these orders are expected to be shipped in fiscal 2009. Backlog as of September 30, 2007 and 2006 was \$14.1 million and \$12.4 million, respectively. Our backlog increase as of September 30, 2008 as compared to September 30, 2007 is partially due to the acquisition of Sarian and Spectrum and a non-cancellable purchase order for \$8.0 million received from a Sarian customer. In addition, our overall backlog increased due to our Drop-in Networking initiative. Backlog as of any particular date is not necessarily indicative of our future sales trends.

**EMPLOYEES**

We had 663 employees on September 30, 2008 compared to 564 employees on September 30, 2007. We acquired 70 employees as a result of the Sarian and Spectrum acquisitions.

**GEOGRAPHIC AREAS**

Our customers are located throughout the North American, European, Middle Eastern & African (EMEA), Asian Pacific and Latin American regions.

We are exposed to foreign currency 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 hedging strategy to reduce foreign currency risk.

**Table of Contents**

**ITEM 1. BUSINESS (CONTINUED)**

**GEOGRAPHIC AREAS (CONTINUED)**

During 2008, we had approximately \$76.1 million of net sales related to foreign customers including export sales, of which \$45.7 million was denominated in foreign currency, predominately the Euro. During 2007 and 2006, we had approximately \$61.2 million and \$55.9 million, respectively, of net sales to foreign customers including export sales, of which \$30.1 million and \$23.3 million, respectively, were denominated in foreign currency, predominately the Euro. In future periods, a significant portion of sales will continue to be made in Euros and British Pounds.

Financial information about geographic areas appears in Note 4 to our Consolidated Financial Statements in this Form 10-K.

**DIGI INTERNATIONAL WEBSITE**

Our Annual Reports on Form 10-K, Proxy Statements, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available through our website ([www.digi.com](http://www.digi.com)) under the About us Investor Relations caption or by writing to us. This information is available free of charge as soon as reasonably practicable after we electronically file such material with the Securities and Exchange Commission. These reports can also be accessed via the SEC website, [www.sec.gov](http://www.sec.gov), or via the SEC's Public Reference Room located at 100 F Street, N.E., Washington, D.C. 20549. Information concerning the operation of the SEC's Public Reference Room can be obtained by calling 1-800-SEC-0330.

We are not including the information on our website as part of, or incorporating it by reference into, our Form 10-K.



**Table of Contents**

**ITEM 1A. RISK FACTORS**

Multiple risk factors exist which could have a material effect on our operations, results of operations, profitability, financial position, liquidity, capital resources and common stock.

**Risks Relating to Our Business**

***Our dependence on new product development and the rapid technological change that characterizes our industry makes us susceptible to loss of market share resulting from competitors' product introductions and similar risks.***

The communications technology industry is characterized by rapidly changing technologies, evolving industry standards, frequent new product introductions, short product life cycles and rapidly changing customer requirements. The introduction of products embodying new technologies and the emergence of new industry standards can render existing products obsolete and unmarketable. Our future success will depend on our ability to enhance our existing products, to introduce new products to meet changing customer requirements and emerging technologies, and to demonstrate the performance advantages and cost-effectiveness of our products over competing products. Failure by us to modify our products to support new alternative technologies or failure to achieve widespread customer acceptance of such modified products could cause us to lose market share and cause our revenues to decline.

We may experience delays in developing and marketing product enhancements or new products that respond to technological change, evolving industry standards and changing customer requirements. There can be no assurance that we will not experience difficulties that could delay or prevent the successful development, introduction, and marketing of these products or product enhancements, or that our new products and product enhancements will adequately meet the requirements of the marketplace and achieve any significant or sustainable degree of market acceptance in existing or additional markets. In addition, the future introductions or announcements of products by us or one of our competitors embodying new technologies or changes in industry standards or customer requirements could render our then-existing products obsolete or unmarketable. There can be no assurance that the introduction or announcement of new product offerings by us or one or more of our competitors will not cause customers to defer their purchase of our existing products, which could cause our revenues to decline.

***We intend to continue to devote significant resources to our research and development, which, if not successful, could cause a decline in our revenues and harm our business.***

We intend to continue to devote significant resources to research and development in the coming years to enhance and develop additional products. For the fiscal years ended 2008, 2007 and 2006, our research and development expenses comprised 14.6%, 14.0% and 14.4%, respectively, of our net sales. If we are unable to develop new products as a result of our research and development efforts, or if the products we develop are not successful, our business could be harmed. Even if we develop new products that are accepted by our target markets, the net revenues from these products may not be sufficient to justify our investment in research and development.

Many of our products have been developed through a combination of internally developed technologies and acquired technologies. Our ability to continue to develop new products is partially dependent on finding and acquiring new technologies in the marketplace. Even if we identify new technologies that we believe would be complementary to our internally developed technologies, we may not be successful in acquiring those technologies or we may not be able to acquire the technologies at a price that is acceptable to us.

A substantial portion of our recent development efforts have been directed toward the development of new products targeted to manufacturers of intelligent, network-enabled devices and other embedded systems in various markets, including markets in which networking solutions for embedded systems have not historically

**Table of Contents****ITEM 1A. RISK FACTORS (CONTINUED)**

been sold, such as markets for industrial automation equipment, security equipment and medical equipment. Our financial performance is dependent upon the development of the intelligent device markets that we are targeting, the increasing adoption of wireless technologies by these markets and our ability to successfully compete and sell our products to manufacturers of these intelligent devices.

***Certain of our products are sold into mature markets, which could limit our ability to continue to generate revenue from these products.***

Certain of our products provide asynchronous and synchronous data transmissions via add-on cards. The market for add-on asynchronous and synchronous data communications cards is mature. Furthermore, certain applications of our embedded network interface cards are also considered mature. As the overall market for these products decreases due to the adoption of new technologies, we expect that our revenues from these products will continue to decline. As a result, our future prospects depend in large part on our ability to acquire or develop and successfully market additional products that address growth markets.

***Our failure to effectively manage product transitions could have a material adverse effect on our revenues and profitability.***

From time to time, we or our competitors may announce new products, capabilities, or technologies that may replace or shorten the life cycles of our existing products. Announcements of currently planned or other new products may cause customers to defer or stop purchasing our products until new products become available. Furthermore, the introduction of new or enhanced products requires us to manage the transition from older product inventories and ensure that adequate supplies of new products can be delivered to meet customer demand. Our failure to effectively manage transitions from older products could have a material adverse effect on our revenues and profitability.

***Our failure to compete successfully in our highly competitive market could result in reduced prices and loss of market share.***

The market in which we operate 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, company reputation, brand recognition, technical support, relationships with partners, quality and reliability, product development capabilities, price, and availability. Certain of our competitors and potential competitors may have greater financial, technological, manufacturing, marketing, and personnel resources than us. Present and future competitors may be able to identify new markets and develop products more quickly, which are superior to those developed by us. They may also adapt new technologies faster, devote greater resources to research and development, promote products more aggressively, and price products more competitively than us. There are no assurances that competition will not intensify or that we will be able to compete effectively in the markets in which we compete.

***Our inability to obtain the appropriate telecommunications carrier certifications or approvals from other governmental regulatory bodies could impede our ability to grow revenues in our wireless products.***

The sale of our wireless products in certain geographical markets is sometimes dependent on the ability to gain telecommunications carrier certifications and/or approvals by certain governmental bodies. Failure to obtain these approvals, or delays in receiving the approvals, could impact our ability to enter our targeted markets or to compete effectively or at all in these markets and could have an adverse impact on our revenues.

**Table of Contents**

**ITEM 1A. RISK FACTORS (CONTINUED)**

***The cyclical nature of the semiconductor industry may result in substantial period-to-period fluctuations in operating results.***

Our semiconductor products provide networking capabilities for intelligent, network-enabled devices and other embedded systems. The semiconductor industry is highly cyclical and subject to rapid technological change and has been subject to significant economic downturns at various times, characterized by diminished product demand, accelerated erosion of average selling prices and production overcapacity. The semiconductor industry also periodically experiences increased demand and production capacity constraints. As a result, we may experience substantial period-to-period fluctuations in operating results due to general semiconductor industry conditions.

***Loss of one or more of our key customers could have an adverse effect on our revenues.***

Our sales are primarily made on the basis of purchase orders rather than under long-term agreements, and therefore, any customer could cease purchasing our products at any time without penalty. The decision of any key customer, including our distributors, to cease using our products or a material decline in the number of units purchased by a significant customer could have a material adverse effect on our revenues.

***The long and variable sales cycle for certain of our products makes it more difficult for us to predict our operating results and manage our business.***

The sale of our products typically involves a significant technical evaluation and commitment of capital and other resources by potential customers and end users, as well as delays frequently associated with end users' internal procedures to deploy new technologies within their products and to test and accept new technologies. For these and other reasons, the sales cycle associated with certain of our products is typically lengthy and is subject to a number of significant risks, including end users' internal purchasing reviews, that are beyond our control. Because of the lengthy sales cycle and the large size of certain customer orders, if orders forecasted for a specific customer are not realized or delayed, our operating results could be materially adversely affected.

***We depend on manufacturing relationships and on limited-source suppliers, and any disruptions in these relationships may cause damage to our customer relationships.***

We procure all parts and certain services involved in the production of our products and subcontract most of our product manufacturing to outside firms that specialize in such services. Although most of the components of our products are available from multiple vendors, we have several single-source supplier relationships, either because alternative sources are not available or because the relationship is advantageous to us. There can be no assurance that our suppliers will be able to meet our future requirements for products and components in a timely fashion. In addition, the availability of many of these components to us is dependent in part on our ability to provide our suppliers with accurate forecasts of our future requirements. Delays or lost sales could be caused by other factors beyond our control, including late deliveries by vendors of components. If we are required to identify alternative suppliers for any of our required components, qualification and pre-production periods could be lengthy and may cause an increase in component costs and delays in providing products to customers. Any extended interruption in the supply of any of the key components currently obtained from limited sources could disrupt our operations and have a material adverse effect on our customer relationships and profitability.

***Our use of suppliers in Southeast Asia involves risks that could negatively impact us.***

We purchase printed circuit boards from suppliers in Southeast Asia. Product delivery times may be extended due to the distances involved, requiring more lead time in ordering. In addition, ocean freight delays may occur as a result of labor problems, weather delays or expediting and customs issues. Any extended delay in receipt of the component parts could eliminate anticipated cost savings and have a material adverse effect on our customer relationships and profitability.

**Table of Contents**

**ITEM 1A. RISK FACTORS (CONTINUED)**

***Our ability to compete could be jeopardized if we are unable to protect our intellectual property rights.***

Our ability to compete depends in part on our proprietary rights and technology. Our proprietary rights and technology are protected by a combination of copyrights, trademarks, trade secrets and patents.

We enter into confidentiality agreements with all employees, and sometimes with our customers and potential customers, and limit access to the distribution of our proprietary information. There can be no assurance that the steps taken by us in this regard will be adequate to prevent the misappropriation of our technology. Our pending patent applications may be denied and any patents, once issued, may be circumvented by our competitors. Furthermore, there can be no assurance that others will not develop technologies that are superior to our technologies. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competing companies will not independently develop similar technology. Our failure to adequately protect our proprietary rights could have a material adverse effect on our competitive position and result in loss of revenue.

***From time to time, we are subject to claims and litigation regarding intellectual property rights or other claims, which could seriously harm us and require us to incur significant costs.***

The communications technology industry is characterized by frequent litigation regarding patent and other intellectual property rights. From time to time, we receive notification of a third-party claim that our products infringe other intellectual property rights. Any litigation to determine the validity of third-party infringement claims, whether or not determined in our favor or settled by us, may be costly and divert the efforts and attention of our management and technical personnel from productive tasks, which could have a material adverse effect on our ability to operate our business and service the needs of our customers. There can be no assurance that any infringement claims by third parties, if proven to have merit, will not materially adversely affect our business or financial condition. In the event of an adverse ruling in any such matter, we may be required to pay substantial damages, cease the manufacture, use and sale of infringing products, discontinue the use of certain processes or be required to obtain a license under the intellectual property rights of the third party claiming infringement. There can be no assurance that a license would be available on reasonable terms or at all. Any limitations on our ability to market our products, or delays and costs associated with redesigning our products or payments of license fees to third parties, or any failure by us to develop or license a substitute technology on commercially reasonable terms could have a material adverse effect on our business and financial condition.

***We face risks associated with our international operations and expansion that could impair our ability to grow our revenues abroad.***

We believe that our future growth is dependent in part upon our ability to increase sales in international markets. These sales are subject to a variety of risks, including fluctuations in currency exchange rates, tariffs, import restrictions and other trade barriers, unexpected changes in regulatory requirements, longer accounts receivable payment cycles, potentially adverse tax consequences, and export license requirements. In addition, we are subject to the risks inherent in conducting business internationally, including political and economic instability and unexpected changes in diplomatic and trade relationships. There can be no assurance that one or more of these factors will not have a material adverse effect on our business strategy and financial condition.

**Table of Contents**

**ITEM 1A. RISK FACTORS (CONTINUED)**

***The loss of key personnel could prevent us from executing our business strategy.***

Our business and prospects depend to a significant degree upon the continuing contributions of our executive officers and our key technical personnel. Competition for such personnel is intense, and there can be no assurance that we will be successful in attracting and retaining qualified personnel. Failure to attract and retain key personnel could result in our failure to execute our business strategy.

***Unanticipated changes in our tax rates could affect our future results.***

Our future effective tax rates could be favorably or unfavorably affected by unanticipated changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws or our interpretation of such laws. In addition, we may be subject to the examination of our income tax returns by the Internal Revenue Service and other U.S. and international tax authorities. We regularly assess the potential outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these examinations will not have an effect on our operating results and financial condition.

***Any acquisitions we have made or will make could disrupt our business and seriously harm our financial condition.***

We will continue to consider acquisitions of complementary businesses, products or technologies. In the event of any future purchases, we could issue stock that would dilute our current stockholders' percentage ownership, incur debt, assume liabilities, or incur large and immediate write-offs.

Our operation of any acquired business may also involve numerous risks, including:

problems combining the purchased operations, technologies, or products;

unanticipated costs;

diversion of management's attention from our core business;

difficulties integrating businesses in different countries and cultures;

adverse effects on existing business relationships with suppliers and customers;

risks associated with entering markets in which we have no or limited prior experience; and

potential loss of key employees, particularly those of the purchased organization.

We cannot assure that we will be able to successfully integrate any businesses, products, technologies, or personnel that we have acquired or that we might acquire in the future and any failure to do so could disrupt our business and have a material adverse effect on our consolidated financial condition and results of operations. Moreover, from time to time, we may enter into negotiations for a proposed acquisition, but be unable or unwilling to consummate the acquisition under consideration. This could cause significant diversion of management's attention and out-of-pocket expenses for us. We could also be exposed to litigation as a result of an unconsummated acquisition, including claims that we failed to negotiate in good faith or misappropriated confidential information.

***Our failure to effectively comply with the requirements of applicable environmental legislation and regulation could have a material adverse effect on our revenues and profitability.***

Production and marketing of products in certain states and countries may subject us to environmental and other regulations. In addition, certain states and countries may pass new regulations requiring our products to meet certain requirements to use environmentally friendly components. Such laws and regulations have recently been passed in jurisdictions in which we operate. The European Union has issued two directives relating to chemical substances in electronic products. The Waste Electrical and Electronic Equipment Directive

**Table of Contents****ITEM 1A. RISK FACTORS (CONTINUED)**

(WEEE) makes producers of certain electrical and electronic equipment financially responsible for collection, reuse, recycling, treatment and disposal of equipment placed in the European Union market after August 13, 2005. The Restrictions of Hazardous Substances Directive (RoHS) bans the use of certain hazardous materials in electric and electrical equipment which are put on the market in the European Union after July 1, 2006. In the future, China and other countries including the United States are expected to adopt further environmental compliance programs. If we fail to comply with these regulations, we may not be able to sell our products in jurisdictions where these regulations apply, which could have a material adverse effect on our revenues and profitability.

***Negative conditions in the global credit markets may impair the liquidity of a portion of our investment portfolio.***

Our investment portfolio consists of commercial paper and corporate bonds. These marketable securities are classified at September 30, 2008 as held-to-maturity and are carried at amortized cost. Recent market conditions indicate significant uncertainty on the part of global investors regarding the global economic outlook and for financial institutions that have potential exposure to the sub-prime housing market. As a result, some of our investments may have experienced reduced liquidity. In addition, we may be required to adjust the carrying value of the securities and record an impairment charge should the impairment be considered as other-than-temporary. This loss would be recorded in our consolidated statement of operations, which could materially adversely impact our consolidated results of operations and financial condition.

***Our consolidated operating results and financial condition may be adversely impacted by worldwide economic conditions and credit tightening.***

Worldwide economic conditions have recently experienced a significant downturn due to the credit conditions impacted by the subprime mortgage crisis and other factors, including slower economic activity, inflation and deflation concerns, increased energy costs, decreased consumer confidence, reduced corporate profits, reduced or canceled capital spending, adverse business conditions and liquidity concerns. These conditions may make it difficult or impossible for our customers and suppliers to accurately forecast and plan future business activities, which may cause them to slow or suspend spending on products and services. As our customers face this challenging economic time, they may find it difficult to gain sufficient credit in a timely manner, which could result in an impairment of their ability to place orders with us or to make timely payments to us for previous purchases. If this occurs, our revenue may be reduced, thereby having a negative impact on our results of operations. In addition, we may be forced to increase our allowance for doubtful accounts and our days sales outstanding may increase, which would have a negative impact on our cash position, liquidity and financial condition. We cannot predict the timing or the duration of this or any other economic downturn in the economy.

***We may have additional tax liabilities.***

We are subject to income taxes in the United States and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes, including our reserves for uncertain tax positions. In the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits could be materially different from our historical income tax provisions and accruals. The results of an audit could have a material effect on our financial position, results of operations, or cash flows in the period or periods for which that determination is made.

**Table of Contents****ITEM 1A. RISK FACTORS (CONTINUED)****Risks Related to Our Common Stock*****If our stock price declines, we may need to recognize an impairment of our goodwill.***

The current global economic crisis has impacted the stock prices of many companies. If the price of our common stock is impacted, we could have an impairment of our goodwill. Our value is dependent upon continued future growth in demand for our products. If such growth does not materialize or our forecasts are significantly reduced, we could have to recognize an impairment of our goodwill. We performed our annual goodwill impairment assessment as of June 30, 2008, on our one reporting unit. Based on our analysis, we conclude that the fair value of our reporting unit exceeds the carrying amount and therefore goodwill is not considered impaired. When the assessment was performed, our market capitalization, which is an indicator of fair value, was below the carrying value of our reporting unit due to significant declines in our stock price during the year. However, an estimated control premium was also used in our determination of fair value. The control premium represents the amount an investor would pay, over and above market capitalization, in order to obtain a controlling interest in a company. Therefore, the fair value of our reporting unit was measured using our market capitalization as of June 30, 2008, plus a control premium in a range of 20% to 30%. The estimated control premium was determined by a review of premiums paid for similar companies over the past five years. The control premium used in our determination of fair value is subject to management judgment, including the interpretation of current economic indicators and market valuations as well as our strategic plans with regard to our operations. To the extent additional information arises or our strategies change, it is possible that our conclusion regarding goodwill impairment could change, which could have a material effect on our financial position and results of operations. At September 30, 2008, our market capitalization, which approximates fair value, exceeded our carrying value.

***The price of our common stock has been volatile and could continue to fluctuate in the future.***

The market price of our common stock, like that of many other high-technology companies, has fluctuated significantly and is likely to continue to fluctuate in the future. During fiscal year 2008, the closing price of our common stock on the NASDAQ Global Select Market ranged from \$7.72 to \$17.13 per share. Our closing sale price on November 28, 2008 was \$9.22 per share. Announcements by us or others regarding the receipt of customer orders, quarterly variations in operating results, acquisitions or divestitures, additional equity or debt financings, results of customer field trials, scientific discoveries, technological innovations, litigation, product developments, patent or proprietary rights, government regulation and general market conditions may have a significant impact on the market price of our common stock.

***Certain provisions of the Delaware General Corporation Law and our charter documents have an anti-takeover effect.***

There exist certain mechanisms under the Delaware General Corporation Law and our charter documents that may delay, defer or prevent a change of control. For instance, under Delaware law, we are prohibited from engaging in certain business combinations with interested stockholders for a period of three years after the date of the transaction in which the person became an interested stockholder unless certain requirements are met, and majority stockholder approval is required for certain business combination transactions with interested parties. Our Certificate of Incorporation contains a fair price provision requiring majority stockholder approval for certain business combination transactions with interested parties, and this provision may not be changed without the vote of at least 80% of the outstanding shares of our voting stock. Other mechanisms in our charter documents may also delay, defer or prevent a change of control. For instance, our Certificate of Incorporation provides that our Board of Directors has authority to issue series of our preferred stock with such voting rights and other powers as the Board of Directors may determine. Furthermore, we have a classified board of directors, which means that our directors are divided into three classes that are elected to three-year terms on a staggered basis. Since the three-year terms of each class overlap the terms of the other classes of directors, the entire board of directors cannot be replaced in any one year.

**Table of Contents**

**ITEM 1A. RISK FACTORS (CONTINUED)**

In addition, under Delaware law, directors serving on a classified board may not be removed by shareholders except for cause. Pursuant to the terms of a shareholder rights plan adopted in 1998 and renewed in 2008, each outstanding share of common stock has one attached right. The rights will cause substantial dilution of the ownership of a person or group that attempts to acquire us on terms not approved by the Board of Directors and may have the effect of deterring hostile takeover attempts. The effect of these anti-takeover provisions may be to deter business combination transactions not approved by our Board of Directors, including acquisitions that may offer a premium over the market price to some or all stockholders.

*We have not paid cash dividends on our common stock and do not expect to do so.*

We have never declared or paid a cash dividend on our common stock. We do not anticipate paying any cash dividends on our common stock in the foreseeable future.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.



**Table of Contents****ITEM 2. PROPERTIES**

The following table contains a listing of our current property locations:

| Location of Property                       | Use of Facility   | Approximate Square Footage | Ownership or Lease Expiration Date |
|--|---|----------------------------|------------------------------------|
| Minnetonka, MN<br>(Corporate headquarters) | Research & development, sales, sales support, marketing, and administration             | 130,000                    | Owned                              |
| Eden Prairie, MN                           | Manufacturing and warehousing   | 58,000                     | Owned                              |
| Minneapolis, MN                            | Engineering services  | 16,837                     | November 2016                      |
| Waltham, MA                                | Research & development, sales and sales support   | 13,424                     | September 2010                     |
| Austin, TX                                 | Sales, sales support, marketing, and administration                                     | 6,563                      | March 2009                         |
| Davis, CA                                  | Sales, sales support, manufacturing and warehousing                                     | 24,000                     | December 2012                      |
| Davis, CA                                  | Marketing, research & development, and administration                                   | 11,200                     | September 2011                     |
| Lindon, UT                                 | Sales, marketing, research & development, and administration                            | 11,986                     | December 2010                      |
| Hong Kong, China                           | Sales, marketing, and administration  | 4,061                      | July 2010                          |
| Beijing, China                             | Sales, marketing, and administration  | 2,372                      | November 2009                      |
| Shanghai, China                            | Sales, marketing, and administration  | 1,251                      | June 2010                          |
| Dortmund, Germany                          | Sales, sales support, marketing, and administration                                     | 21,485                     | March 2013                         |
| Breisach, Germany                          | Sales, marketing, research & development, manufacturing, warehousing and administration | 8,748                      | December 2009                      |
| Ilkley, UK                                 | Sales, sales support, marketing and administration                                      | 5,475                      | September 2015                     |
| Ilkley, UK                                 | Warehousing   | 1,058                      | August 2009                        |
| Logrono, Spain                             | Sales, research & development, and administration                                       | 3,228                      | January 2017                       |
| Tokyo, Japan                               | Sales   | 1,371                      | November 2009                      |

In addition to the above locations, we perform research and development activities in various other locations in the United States and sales activities in various other locations in Europe and China which are not deemed to be principal locations. We believe that our facilities are adequate for our needs. In February 2008, we sold our facility in Dortmund, Germany and leased back approximately 40% of the property for a period of five years, with a renewal option for an additional five years.

**Table of Contents****ITEM 3. LEGAL PROCEEDINGS**

On April 19, 2002, a consolidated amended class action complaint was filed in the United States District Court for the Southern District of New York asserting claims relating to the initial public offering (IPO) of our subsidiary NetSilicon, Inc. and approximately 300 other public companies. The complaint names us as a defendant along with NetSilicon, certain of its officers and certain underwriters involved in NetSilicon's IPO, among numerous others, and asserts, among other things, that NetSilicon's IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of NetSilicon's IPO underwriters in allocating shares in NetSilicon's IPO to the underwriters' customers. We believe that the claims against the NetSilicon defendants are without merit and have defended the litigation vigorously. Pursuant to a stipulation between the parties, the two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002. In June 2003, we elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. Had it been approved by the Court, this proposed settlement would have resulted in a dismissal, with prejudice, of all claims in the litigation against us and against any of the other issuer defendants who elected to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants. This proposed settlement was conditioned on, among other things, a ruling by the District Court that the claims against NetSilicon and against the other issuers who had agreed to the settlement would be certified for class action treatment for purposes of the proposed settlement, such that all investors included in the proposed classes in these cases would be bound by the terms of the settlement unless an investor opted to be excluded from the settlement in a timely and appropriate fashion.

On December 5, 2006, the U.S. Court of Appeals for the Second Circuit issued a decision in In re Initial Public Offering Securities Litigation that six purported class action lawsuits containing allegations substantially similar to those asserted against us could not be certified as class actions due, in part, to the Court of Appeals' determination that individual issues of reliance and knowledge would predominate over issues common to the proposed classes. On January 8, 2007, the plaintiffs filed a petition seeking rehearing en banc of this ruling. On April 6, 2007 the Court of Appeals denied the plaintiffs' petition for rehearing of the Court's December 5, 2006 ruling. The Court of Appeals, however, noted that the plaintiffs remained free to ask the District Court to certify classes different from the ones originally proposed which might meet the standards for class certification that the Court of Appeals articulated in its December 5, 2006 decision. The plaintiffs have since moved for certification of different classes in the District Court, and that motion remains pending.

In light of the Court of Appeals' December 5, 2006 decision regarding certification of the plaintiffs' claims, the District Court entered an order on June 25, 2007 terminating the proposed settlement between the plaintiffs and the issuers, including NetSilicon. Because any possible future settlement with the plaintiffs, if a settlement were ever to be negotiated and ultimately agreed to, would involve the certification of a class action for settlement purposes, the impact of the Court of Appeals' rulings on the possible future settlement of the claims against NetSilicon is uncertain. On August 14, 2007, the plaintiffs filed amended complaints in the six focus cases. The issuer defendants and the underwriter defendants separately moved to dismiss the claims against them in the amended complaints in the six focus cases. On March 26, 2008, the District Court issued an order in which it denied in substantial part the motions to dismiss the amended complaints in the six focus cases. In addition, on October 1, 2007, the plaintiffs submitted their briefing in support of their motions to certify different classes in the six focus cases. The issuer defendants and the underwriter defendants filed separate oppositions to those motions on December 21, 2007. The plaintiffs have voluntarily withdrawn their motions for class certification without prejudice.

**Table of Contents**

**ITEM 3. LEGAL PROCEEDINGS (CONTINUED)**

We intend to continue to defend the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit. We maintain liability insurance for such matters and expect that the liability insurance will be adequate to cover any potential unfavorable outcome, less the applicable deductible amount of \$250,000 per claim. As of September 30, 2008, we have accrued a liability for the deductible amount of \$250,000 which we believe reflects the amount of loss that is probable. In the event we have losses that exceed the limits of the liability insurance, such losses could have a material effect on our business and our consolidated results of operations or financial condition.

In addition to the matter 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.

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

There were no matters submitted to the vote of security holders during the fourth quarter of the fiscal year ended September 30, 2008.

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Stock Listing**

Our Common Stock trades under the symbol DGII. Since July 3, 2006 our Common Stock has traded on the NASDAQ Global Select Market tier of the NASDAQ Stock Market LLC and prior to that time was traded on the NASDAQ National Market tier. On November 28, 2008, the number of holders of our Common Stock was approximately 8,669, consisting of 205 record holders and approximately 8,464 stockholders whose stock is held by a bank, broker or other nominee.

High and low sale prices for each quarter during the years ended September 30, 2008 and 2007, as reported on the NASDAQ Stock Market LLC, were as follows:

**Stock Prices**

|      |          |          |          |          |
|------|----------|----------|----------|----------|
| 2008 | First    | Second   | Third    | Fourth   |
| High | \$ 17.30 | \$ 14.46 | \$ 12.82 | \$ 12.87 |
| Low  | \$ 13.34 | \$ 10.20 | \$ 7.64  | \$ 7.67  |
| 2007 | First    | Second   | Third    | Fourth   |
| High | \$ 14.50 | \$ 13.93 | \$ 15.67 | \$ 16.71 |
| Low  | \$ 12.99 | \$ 11.39 | \$ 12.02 | \$ 13.12 |

**Dividend Policy**

We have never paid cash dividends on our Common Stock. Our Board of Directors presently intends to retain all earnings for use in our business, except for stock repurchases, and does not anticipate paying cash dividends in the foreseeable future.

We do not have a Dividend Reinvestment Plan or a Direct Stock Purchase Plan.

**Issuer Repurchases of Equity Securities**

On July 23, 2008, our Board of Directors authorized an additional 500,000 shares of our common stock for repurchase under our previously announced stock repurchase program. The total number of shares authorized to be repurchased is 1,500,000 shares. During the fourth quarter of fiscal 2008, we began to repurchase our common stock in the open market. The following table presents our repurchases during the fourth quarter of fiscal 2008:

| Fiscal Period                          | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid<br>per<br>Share | Total Number of<br>Shares<br>Purchased<br>as Part of a<br>Publicly<br>Announced<br>Program | Maximum<br>Number<br>of Shares that<br>May<br>Yet Be<br>Purchased<br>Under the<br>Program |
|--|---|--|--|---|
| July 1, 2008 - July 31, 2008           | 168,800                                   | \$ 10.22                                 | 168,800  | 1,331,200   |
| August 1, 2008 - August 31, 2008       | 140,000                                   | \$ 10.52                                 | 140,000  | 1,191,200   |
| September 1, 2008 - September 30, 2008 | 162,400                                   | \$ 11.74                                 | 162,400  | 1,028,800   |
| Total                                  | 471,200                                   | \$ 10.83                                 | 471,200  | 1,028,800   |

**Table of Contents****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS  
AND ISSUER PURCHASES OF EQUITY SECURITIES (CONTINUED)****Performance Evaluation**

The graph below compares the total cumulative stockholders' return on our Common Stock for the period from the close of the Nasdaq Stock Market U.S. Companies on September 30, 2003 to September 30, 2008, the last day of fiscal 2008, with the total cumulative return on the CRSP Total Return Index for the Nasdaq Stock Market U.S. Companies (the CRSP Index) and the CRSP Index for Nasdaq Telecommunications Stocks (the Peer Index) over the same period. We have determined that our line of business is mostly comparable to those companies in the Peer Index. The index level for the graph and table was set to \$100 on September 30, 2003, for our Common Stock, the CRSP Index and the Peer Index and assumes the reinvestment of all dividends.

|                         | <b>FY03</b> | <b>FY04</b> | <b>FY05</b> | <b>FY06</b> | <b>FY07</b> | <b>FY08</b> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Digi International Inc. | 100.00      | 172.68      | 162.11      | 203.96      | 215.14      | 154.10      |
| CRSP Index              | 100.00      | 106.23      | 121.26      | 127.87      | 151.34      | 119.35      |
| Peer Index              | 100.00      | 100.33      | 122.48      | 136.64      | 160.20      | 111.13      |

26

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA**

(In thousands except per common share amounts and number of employees)

| For the fiscal years ended September 30  | 2008       | 2007       | 2006       | 2005       | 2004       |
|--|------------|------------|------------|------------|------------|
| Net sales (1)  | \$ 185,056 | \$ 173,263 | \$ 144,663 | \$ 125,198 | \$ 111,226 |
| Gross profit   | \$ 97,869  | \$ 91,346  | \$ 77,505  | \$ 71,491  | \$ 63,469  |
| Sales and marketing  | 36,879     | 33,499     | 28,591     | 26,339     | 25,556     |
| Research and development   | 27,040     | 24,176     | 20,861     | 16,531     | 17,159     |
| General and administrative   | 16,035     | 13,343     | 12,830     | 11,364     | 8,973      |
| Acquired in-process research and development                                     | 1,900      |            | 2,000      | 300        |            |
| Operating income (2)   | 16,015     | 20,328     | 13,223     | 16,957     | 11,781     |
| Total other income, net (3)  | 2,900      | 3,396      | 2,044      | 1,026      | 369        |
| Income before income taxes   | 18,915     | 23,724     | 15,267     | 17,983     | 12,150     |
| Income tax provision (4)   | 6,564      | 3,951      | 4,154      | 318        | 3,487      |
| Net income   | \$ 12,351  | \$ 19,773  | \$ 11,113  | \$ 17,665  | \$ 8,663   |
| Net income per common share, basic:  |            |            |            |            |            |
| Basic  | \$ 0.48    | \$ 0.78    | \$ 0.48    | \$ 0.79    | \$ 0.41    |
| Diluted  | \$ 0.47    | \$ 0.76    | \$ 0.46    | \$ 0.76    | \$ 0.39    |
| Balance sheet data as of September 30:   |            |            |            |            |            |
| Working capital (total current assets less total current liabilities)            | \$ 112,236 | \$ 115,703 | \$ 83,341  | \$ 69,995  | \$ 82,090  |
| Total assets   | \$ 271,416 | \$ 251,826 | \$ 225,321 | \$ 177,631 | \$ 150,465 |
| Long-term debt and capital lease obligations                                     | \$ 345     | \$ 358     | \$ 725     | \$ 1,181   | \$         |
| Stockholders' equity   | \$ 231,934 | \$ 222,905 | \$ 193,830 | \$ 153,537 | \$ 127,079 |
| Book value per common share (stockholders' equity divided by outstanding shares) | \$ 9.14    | \$ 8.73    | \$ 7.74    | \$ 6.78    | \$ 5.83    |
| Number of employees as of September 30   | 663        | 564        | 549        | 481        | 341        |

(1) Acquisitions provided the following net sales during the year of acquisition: Sarian and Spectrum in fiscal 2008 of \$6.5 million, MaxStream in fiscal 2006 of \$3.2 million, Rabbit and FS Forth of \$13.3 million in fiscal 2005.

- (2) Effective October 1, 2005, we adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R), using the modified prospective method of application. Total compensation cost for stock-based payment arrangements totaled \$3.7 million (\$2.5 million after tax) during fiscal 2008, \$3.0 million (\$2.0 million after tax) during fiscal 2007, and \$2.3 million (\$1.5 million after tax) during fiscal 2006. Prior to the adoption of this Statement, no compensation cost for stock-based payment arrangements was recognized in earnings. Refer to Note 9 to our Consolidated Financial Statements for further discussion.
- (3) Included in total other income, net is an other-than-temporary impairment charge of \$1.0 million (\$0.7 million after tax) recorded during the fourth quarter of fiscal 2008 on an investment in a bond issued by Lehman Brothers (see Note 12 to our Consolidated Financial Statements).

- (4) In fiscal 2008, we recorded a net discrete tax benefit of \$0.5 million resulting from a reversal of previously established tax reserves associated with the closing of a prior tax year. In fiscal 2007, we reversed income tax reserves of \$3.6 million associated with the closing of a German tax audit and the statutory closing of a prior U.S. federal and state tax year. We also recorded other discrete tax benefits of \$0.7 million in fiscal 2007 (see Note 8 to our Consolidated Financial Statements). In fiscal 2006 and 2005, we reversed income tax reserves of \$1.6 million and \$5.7 million, respectively, primarily due to settlement of tax audits with the French government in 2006 and the Internal Revenue Service in 2005.



**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**OVERVIEW**

We operate in the communications technology industry, which is characterized by rapid technological advances and evolving industry standards. The market can be significantly affected by new product introductions and marketing activities of industry participants. We compete for customers on the basis of existing and planned product features, service capabilities, company reputation, brand recognition, technical support, relationships with partners, quality and reliability, product development capabilities, price and availability. We help customers connect, monitor, and control local or remote electronic devices over a network or via the Internet. We continue to leverage a common core technology base to develop and provide innovative connectivity solutions to our customers. Core technology is used across product lines to provide additional functionality for customers, allowing them to get to market with network-enabled devices faster. We have positioned ourselves in the growing market of integrated hardware and software connectivity solutions to network-enable the coming generation of intelligent devices in commercial applications.

Our revenues consist of products that are in non-embedded and embedded product groupings. The non-embedded products include serial cards, serial servers, USB connected products, cellular routers, cellular gateway products, network management software, console servers, remote display products, wireless communications adapters, and cameras and sensors. Embedded products include chips, modules, single-board computers, Network Interface Cards (NICs) and software and development tools and engineering design services. Our non-embedded serial cards and our embedded NICs are in the mature phase of their product life cycles. Our strategy is to focus on key applications, customers and markets to efficiently manage the migration from products that are in the mature phase of their product life cycles to other newer technologies.

In April 2008, we acquired Sarian Systems, Ltd. ( Sarian ), a leader in the European wireless router market. Sarian designs, develops and manufactures advanced wireless/cellular IP-based routing equipment for mission critical applications. Sarian developed its own comprehensive IP-based operating system and software and can offer customers technical excellence, flexibility and rapid customization. Sarian has a strong customer base in ATM connectivity, retail and payment systems connectivity, remote monitoring telemetry, lottery terminal connectivity and wireless backup of wired broadband connections.

In July 2008, we acquired Spectrum Design Solutions Inc. ( Spectrum ), a leading design services organization. Spectrum focuses on solving a customer's wireless development challenges. Spectrum's engineers have extensive experience in wireless technologies such as GSM, CDMA, GPS, Wi-Fi and proprietary RF as well as ASIC design, FPGA integration, embedded software and complete turn-key product development which allows them to address virtually any wireless development need.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**  
**CONSOLIDATED RESULTS OF OPERATIONS**

The following table sets forth selected information from our Consolidated Statements of Operations, expressed as a percentage of net sales and as a percentage of change from year-to-year for the years indicated.

|  | Year ended September 30, |        |            |        |            |        | % Increase<br>(decrease)       |                                |
|--|--------------------------|--------|------------|--------|------------|--------|--------------------------------|--------------------------------|
|  | 2008                     |        | 2007       |        | 2006       |        | 2008<br>compared<br>to<br>2007 | 2007<br>compared<br>to<br>2006 |
| (\$ in thousands)  |                          |        |            |        |            |        |                                |                                |
| Net sales  | \$ 185,056               | 100.0% | \$ 173,263 | 100.0% | \$ 144,663 | 100.0% | 6.8%                           | 19.8%                          |
| Cost of sales<br>(exclusive of<br>amortization of<br>purchased and core<br>technology shown<br>separately below) | 83,096                   | 44.9   | 77,376     | 44.7   | 62,322     | 43.1   | 7.4                            | 24.2                           |
| Amortization of<br>purchased and core<br>technology  | 4,091                    | 2.2    | 4,541      | 2.6    | 4,836      | 3.3    | (9.9)                          | (6.1)                          |
| Gross profit   | 97,869                   | 52.9   | 91,346     | 52.7   | 77,505     | 53.6   | 7.1                            | 17.9                           |
| Operating<br>expenses:   |                          |        |            |        |            |        |                                |                                |
| Sales and marketing  | 36,879                   | 20.0   | 33,499     | 19.3   | 28,591     | 19.8   | 10.1                           | 17.2                           |
| Research and<br>development  | 27,040                   | 14.6   | 24,176     | 14.0   | 20,861     | 14.4   | 11.8                           | 15.9                           |
| General and<br>administrative  | 16,035                   | 8.6    | 13,343     | 7.7    | 12,830     | 8.9    | 20.2                           | 4.0                            |
| In-process research<br>and development   | 1,900                    | 1.0    |            |        | 2,000      | 1.4    | N/M                            | N/M                            |
| Total operating<br>expenses  | 81,854                   | 44.2   | 71,018     | 41.0   | 64,282     | 44.5   | 15.3                           | 10.5                           |
| Operating income   | 16,015                   | 8.7    | 20,328     | 11.7   | 13,223     | 9.1    | (21.2)                         | 53.7                           |
| Total other income,<br>net   | 2,900                    | 1.5    | 3,396      | 2.0    | 2,044      | 1.4    | (14.6)                         | 66.1                           |
| Income before<br>income taxes  | 18,915                   | 10.2   | 23,724     | 13.7   | 15,267     | 10.5   | (20.3)                         | 55.4                           |
| Income tax<br>provision  | 6,564                    | 3.5    | 3,951      | 2.3    | 4,154      | 2.8    | 66.1                           | (4.9)                          |
| Net income   | \$ 12,351                | 6.7%   | \$ 19,773  | 11.4%  | \$ 11,113  | 7.7%   | (37.5)%                        | 77.9%                          |

N/M means not  
meaningful

**NET SALES**

Net sales were \$185.1 million in fiscal 2008 compared to \$173.3 million in fiscal 2007, an increase of \$11.8 million, or 6.8%. Net sales included five months of Sarian product sales of \$5.7 million and two months of Spectrum product sales of \$0.8 million based on their dates of acquisition. Net sales of all other products, except serial cards and NICs, increased by \$8.7 million, or 5.8%. Net sales of serial cards, a non-embedded product, and NICs, an embedded product, decreased by \$3.4 million, or 14.6%. Serial cards are in a mature market that is declining at a rate of approximately 15% - 20% per year. Serial cards net sales represented 10.0% of total net sales for fiscal 2008. NICs are at the end of their product life cycle and represented less than 1% of our net sales for fiscal 2008.

Net sales increased from 2006 to 2007 by \$28.6 million, or 19.8%. Net sales increased \$17.4 million as a result of a full year of product sales related to the acquisition of MaxStream which were \$20.6 million in fiscal 2007 compared to \$3.2 million in fiscal 2006, as fiscal 2006 net sales only included two months of revenue based on the date of acquisition of July 27, 2006. Net sales of all other products, except serial cards and NICs, increased by \$19.7 million, or 18.0%. Net sales of serial cards, which are a non-embedded product, and NICs, which are an embedded product, decreased by \$8.5 million, or 26.9%, as serial cards are in a mature market and NICs are approaching the end of their product life cycle.

A shift in the customer and product mix has resulted in a slight decrease in our average selling price of our products as we are selling more embedded products as a percentage of total net sales. Embedded products generally have a lower average selling price than non-embedded products. Fluctuation in foreign currency rates compared to the prior year's rates in each case had a favorable impact on net sales of \$2.2 million in fiscal 2008, a favorable impact on net sales of \$2.3 million in fiscal 2007 and an unfavorable impact on net sales of \$0.6 million in fiscal 2006.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****NET SALES (CONTINUED)****Net Sales by Products**

The following table presents our revenue by product grouping:

| (\$ in millions) | Net Sales |          |          | % of Net Sales |        |        |
|------------------|-----------|----------|----------|----------------|--------|--------|
|                  | 2008      | 2007     | 2006     | 2008           | 2007   | 2006   |
| Non-embedded     | \$ 98.5   | \$ 98.9  | \$ 86.7  | 53.2%          | 57.1%  | 59.9%  |
| Embedded         | 86.6      | 74.4     | 58.0     | 46.8%          | 42.9%  | 40.1%  |
| Total            | \$ 185.1  | \$ 173.3 | \$ 144.7 | 100.0%         | 100.0% | 100.0% |

**Non-Embedded**

Our non-embedded products net sales decreased \$0.4 million in fiscal 2008 compared to fiscal 2007. Serial card revenue continued to decline along with a reduction of serial server revenue, partially offset by an increase in revenue in wireless routers due to the acquisition of Sarian.

Our non-embedded products net sales increased \$12.2 million, or 14.1%, in fiscal 2007 compared to fiscal 2006 due to an increase in sales of serial servers, USB connected products and wireless communication adapters and gateways, partially offset by the sales decline of serial cards.

**Embedded**

Embedded products net sales increased \$12.2 million, or 16.4%, in fiscal 2008 compared to fiscal 2007. Net sales of modules including wireless modules increased \$9.6 million in fiscal 2008 compared to fiscal 2007. The remaining increase was due to an increase in design services revenue as a result of the acquisition of Spectrum along with an increase in chips and software revenue, partially offset by a slight decline of the NIC sales.

Embedded products net sales increased \$16.4 million, or 28.2%, in fiscal 2007 compared to fiscal 2006. An increase in net sales of embedded modules and single-board computers was partially offset by the decline of the NIC sales.

**Net Sales by Distribution Channels**

The following table presents our revenue by distribution channel:

| (\$ in millions)     | Net Sales |          |          | % of Net Sales |        |        |
|----------------------|-----------|----------|----------|----------------|--------|--------|
|                      | 2008      | 2007     | 2006     | 2008           | 2007   | 2006   |
| Direct / OEM channel | \$ 87.5   | \$ 88.6  | \$ 70.3  | 47.3%          | 51.1%  | 48.6%  |
| Distribution channel | 97.6      | 84.7     | 74.4     | 52.7%          | 48.9%  | 51.4%  |
| Total company        | \$ 185.1  | \$ 173.3 | \$ 144.7 | 100.0%         | 100.0% | 100.0% |

During fiscal 2008, net sales in the Direct/OEM channel decreased due to a decline in net sales in North America and a change in the product mix. The increase in Direct / OEM channel net sales during fiscal 2007 is primarily due to continued enhancement of our product offerings through the acquisitions of Rabbit and MaxStream, whose customers are primarily OEMs.

The increase in the Distribution channel net sales over the last three fiscal years was primarily due to our continued focus on maintaining our channel strategy, which includes employing additional channel partners and releasing complementary products. In addition, net sales from our international customers, which are primarily fulfilled through the distribution channel grew faster than our domestic net sales in fiscal 2008.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****NET SALES (CONTINUED)****Net Sales by Geographic Area**

Our revenue by geographic location of our customers is as follows:

| (\$ in millions) | Net Sales |          |          | % of Net Sales |        |        |
|------------------|-----------|----------|----------|----------------|--------|--------|
|                  | 2008      | 2007     | 2006     | 2008           | 2007   | 2006   |
| North America    | \$ 107.3  | \$ 112.0 | \$ 88.8  | 58.0%          | 64.7%  | 61.4%  |
| International    | 77.8      | 61.3     | 55.9     | 42.0%          | 35.3%  | 38.6%  |
| Total Company    | \$ 185.1  | \$ 173.3 | \$ 144.7 | 100.0%         | 100.0% | 100.0% |

The decrease in net sales in North America in fiscal 2008 is primarily due a reduction in net sales of non-embedded products, partially offset by the increase in embedded products which includes the incremental net sales resulting from the Spectrum acquisition. The increase in net sales in North America increased during fiscal 2007 as compared to fiscal 2006 due to incremental net sales resulting from the MaxStream and Rabbit acquisitions, continued market penetration and new customer volume increases.

The increase in international revenue during the past three fiscal years is due primarily to the increase in the European, Middle Eastern, and African ( EMEA ) locations including the incremental net sales increase of \$5.7 million resulting from the Sarian acquisition in fiscal 2008. Revenue increased in the Latin American and Asian Pacific locations by \$4.9 million in fiscal 2008 compared to fiscal 2007.

**GROSS PROFIT****2008 Compared to 2007**

The gross margin for 2008 was 52.9% compared to 52.7% in 2007. The increase in gross margin is due to a reduction in the amortization of purchased and core technology, partially offset by a decrease in gross margin due to product mix changes among products within both the embedded and non-embedded product groups, including lower gross margins provided by Sarian non-embedded products. Amortization of purchased and core technology was \$4.1 million or 2.2% of net sales in fiscal 2008 as compared to \$4.5 million or 2.6% of net sales in fiscal 2007.

**2007 Compared to 2006**

Gross margin for 2007 was 52.7% compared to 53.6% for 2006. The decrease in gross margin is primarily a result of product and customer mix changes related to the increase in embedded net sales. This was offset by an increase in gross margin of 0.7% due to reduced amortization of purchased and core technology since some of this technology became fully amortized in 2007. Amortization of purchased and core technology was \$4.5 million or 2.6% of net sales in fiscal 2007 as compared to \$4.8 million or 3.3% of net sales in fiscal 2006.

**OPERATING EXPENSES****2008 Compared to 2007**

Operating expenses were \$81.9 million in 2008, an increase of \$10.9 million or 15.3%, compared to operating expenses of \$71.0 million in 2007. The incremental operating expenses resulting from the acquisition of Sarian on April 28, 2008, were \$3.6 million, which includes a \$1.9 million charge for in-process research and development expenses. The Spectrum acquisition resulted in additional operating expenses of \$0.4 million. Compensation-related expenses, including salaries and cash incentive compensation and stock-based compensation, increased by \$3.1 million in fiscal 2008 compared to fiscal 2007 due to merit increases and an increase in employees primarily as a result of acquisitions, offset by a lower level of cash incentive compensation based on lower than planned revenue and other defined performance measures. The remaining

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)  
OPERATING EXPENSES (CONTINUED)**

\$3.8 million increase in operating expenses was primarily due to incremental spending related to our Drop-in Networking initiative.

Sales and marketing expenses were \$36.9 million in 2008, an increase of \$3.4 million or 10.1%, compared to sales and marketing expenses of \$33.5 million in 2007. The incremental expenses related to the Sarian and Spectrum acquisitions increased sales and marketing expenses by \$0.9 million. In addition, sales and marketing expenses increased by \$1.4 million for compensation-related expenses, \$0.6 million for advertising and marketing literature and by \$0.5 million for miscellaneous other sales and marketing expenses.

Research and development expenses were \$27.1 million in 2008, an increase of \$2.9 million or 11.8%, compared to research and development expenses of \$24.2 million in 2007. The incremental expenses related to the Sarian and Spectrum acquisitions increased research and development expenses by \$0.4 million. Other increases in research and development expenses were \$1.2 million for compensation-related expenses, \$0.5 million for product certification testing, \$0.3 million for professional fees and \$0.5 million for other research and development expenses.

General and administrative expenses were \$16.0 million in 2008, an increase of \$2.7 million or 20.2%, compared to general and administrative expenses of \$13.3 million in 2007. The incremental expenses related to the Sarian and Spectrum acquisitions increased general and administrative expenses by \$0.9 million. In addition, general and administrative expenses increased by \$0.4 million as we recognized only a \$0.1 million gain on the sale of the Dortmund, Germany building during fiscal 2008 compared to a one-time \$0.5 million gain in 2007 on the sale of undeveloped land in Davis, California. Other increases in general and administrative expenses were primarily due to \$0.5 million of compensation-related expenses, \$0.4 million due to bad debt expense and \$0.5 million in professional fees.

**2007 Compared to 2006**

Operating expenses were \$71.0 million in 2007, an increase of \$6.7 million or 10.5%, compared to operating expenses of \$64.3 million in 2006. The incremental operating expenses resulting from the acquisition of MaxStream on July 27, 2006 provided an additional \$4.6 million of operating expenses, which was offset by a \$2.0 million charge for in-process research and development in the fourth quarter of fiscal 2006 in connection with the acquisition of MaxStream. Compensation-related expenses, including salaries and cash incentive compensation and stock-based compensation, increased by \$4.5 million in fiscal 2007 as compared to fiscal 2006 due to an increase in employees, merit increases and a higher level of cash incentive compensation achievement based on revenue and other defined performance measures.

Sales and marketing expenses were \$33.5 million in 2007, an increase of \$4.9 million or 17.2%, compared to sales and marketing expenses of \$28.6 million in 2006. The incremental expenses related to the MaxStream acquisition increased sales and marketing expenses by \$2.2 million. In addition, sales and marketing expenses increased by \$2.4 million for compensation-related expenses and by \$0.3 million for miscellaneous other sales and marketing expenses.

Research and development expenses were \$24.2 million in 2007, an increase of \$3.3 million or 15.9%, compared to research and development expenses of \$20.9 million in 2006. The incremental research and development expenses related to the MaxStream acquisition accounted for \$1.7 million of the increase. The remaining increase of \$1.6 million is primarily a result of compensation-related expenses.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****OPERATING EXPENSES (CONTINUED)**

General and administrative expenses were \$13.3 million in 2007, an increase of \$0.5 million or 4.0%, compared to general and administrative expenses of \$12.8 million in 2006. General and administrative expenses increased \$0.7 million due to the incremental expenses related to the MaxStream acquisition, \$0.5 million due to compensation-related expenses, \$0.3 million due to bad debt expense, \$0.2 million due to the gain on sale of intellectual property sold in fiscal 2006 and the remaining \$0.4 million is due to maintenance expense and other related general and administrative expenses. Professional fees decreased by \$1.1 million in fiscal 2007 as compared to fiscal 2006, primarily related to reduced legal fees as well as reduced consulting fees. We also recorded a \$0.5 million gain related to the sale of land in the fourth quarter of fiscal 2007.

**ACQUIRED IN-PROCESS RESEARCH AND DEVELOPMENT****Sarian Systems, Ltd.**

On April 28, 2008, we acquired Sarian Systems, Ltd. ( Sarian ), which is now a wholly owned subsidiary of Digi International Ltd. Prior to the acquisition, Sarian was a privately held corporation. Sarian is located in the United Kingdom and is a leader in the European wireless router market. The total purchase price of \$30.9 million (including \$3.1 million of cash acquired) was for all of the outstanding ordinary shares of Sarian.

At the time of acquisition, Sarian had development projects in process associated with the IPV6, Gate Array and VPN technologies. We estimated that \$1.9 million of the purchase price represented the fair value of acquired in-process research and development related to the products listed below (in thousands):

|   |          |
|---|----------|
| IPV6                                      | \$ 1,300 |
| Gate Array                                | 400      |
| VPN technologies                          | 200      |
| Total in-process research and development | \$ 1,900 |

These products were under development, had a measurable percentage completed and a documented expected life, had not yet reached technological feasibility, and had no alternative future uses. This amount was expensed as a non-tax-deductible charge upon consummation of the acquisition.

We anticipate that all the projects will be completed by the end of calendar year 2008 and are expected to start generating revenues beginning in calendar year 2009. The estimates described above are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur.

**MaxStream, Inc.**

On July 27, 2006, we acquired MaxStream, Inc. ( MaxStream ), a privately held corporation. The total purchase price of \$40.5 million included \$19.8 million in cash (including cash acquired of \$3.7 million) and \$20.7 million in common stock, in exchange for all outstanding shares of MaxStream's preferred and common stock and outstanding stock options. We did not replace MaxStream's outstanding options with Digi options.

At the time of acquisition, MaxStream had development projects in process associated with the XStream Gen. 2, X. Eleven, Mesh Firmware, Xbee Zigbee Firmware and Xplore products. We estimated that \$2.0 million of the purchase price represented the fair value of acquired in-process research and development related to the products listed below (in thousands) that were under development, had a measurable percentage completed and a documented expected life, had not yet reached technological feasibility, and had no alternative future uses. This amount was expensed as a non-tax-deductible charge upon consummation of the acquisition.

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**  
**ACQUIRED IN-PROCESS RESEARCH AND DEVELOPMENT (CONTINUED)**

|   |              |
|---|--------------|
| XStream Gen. 2                                | \$ 900       |
| X. Eleven                                     | 500          |
| Mesh Firmware                                 | 400          |
| Xbee Zigbee Firmware                          | 100          |
| Xplore  | 100          |
| <br>Total in-process research and development | <br>\$ 2,000 |

The Xplore and Mesh Firmware projects were released during fiscal year 2007. The XStream Gen. 2 along with the Xbee Zigbee Firmware projects were released in fiscal year 2008. The X. Eleven project is scheduled to be completed during fiscal 2009. These estimates are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur. We anticipate that the projected revenue from these projects will be in line with original projections.

**OTHER INCOME, NET****2008 Compared to 2007**

Total other income, net was \$2.9 million in fiscal 2008 compared to \$3.4 million in fiscal 2007. We realized interest income on marketable securities and cash and cash equivalents of \$3.6 million in fiscal 2008 compared to \$3.5 million in fiscal 2007. The increase in interest income was primarily due to a higher average investment balance of \$77.1 million in fiscal 2008 compared to \$66.7 million in fiscal 2007, which was partially offset by a decrease in the average interest rate. Before impairment on the Lehman Brothers bond, we earned an average interest rate of approximately 4.5% during fiscal 2008 compared to an approximate rate of 5.1% for fiscal 2007. Interest expense was \$0.2 million in fiscal 2008 primarily related to interest on the \$25.0 million short-term loan that was used to finance the Sarian acquisition, interest on capital leases and interest accrued on the deferred payment for the Spectrum acquisition. The short-term loan was paid in full in May 2008. We also recorded an other-than-temporary impairment charge of \$1.0 million in fiscal 2008 for the Lehman Brothers bond included in our marketable securities portfolio (see Note 12 to our Consolidated Financial Statements). Included in other income, net for fiscal 2008, is \$0.5 million of net foreign currency transaction gains.

**2007 Compared to 2006**

Other income, net was \$3.4 million in fiscal 2007, an increase of \$1.4 million compared to \$2.0 million in fiscal 2006. During fiscal 2007, we realized \$3.5 million of interest income on marketable securities and cash and cash equivalents compared to \$2.4 million during fiscal 2006. The increase in interest income was due to higher average investment balances and higher average interest rates. The average investment balance during fiscal 2007 was \$66.7 million compared to \$52.6 million for fiscal 2006. We earned an average interest rate of 5.1% during fiscal 2007 compared to 4.3% for fiscal 2006. Interest expense was \$0.1 million for fiscal 2007 and related to our capital leases.

**INCOME TAXES**

Our effective income tax rate was 34.7%, 16.7% and 27.2% for fiscal 2008, 2007 and 2006, respectively.

During fiscal 2008, we reversed \$0.3 million in income tax reserves primarily associated with the statutory closing of a prior U.S. federal and state tax year. We recorded an additional \$0.2 million of discrete tax benefits as a result of a filing of a prior year tax return and adjustments to actual for items reported on the tax returns for fiscal 2007.



**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)  
INCOME TAXES (CONTINUED)**

During fiscal 2007, we reversed \$3.6 million in income tax reserves associated with the closing of a German tax audit and the statutory closing of a prior U.S. federal and state tax year. We also recorded other discrete tax benefits of \$0.7 million primarily related to the filing of U.S. amended tax returns, enactment of the extension of the research and development tax credit, and adjustments to actual for items reported on the tax returns filed for fiscal 2006. The aforementioned income tax benefits resulting from the reversal of income tax reserves and other discrete tax benefits reduced the effective tax rate by 18.2 percentage points in fiscal 2007.

During fiscal 2006, we recorded \$1.6 million in discrete tax benefits, primarily related to an audit of prior fiscal years which was settled with the French government in 2006. We had established excess tax reserves that were no longer required as a result of the settlement. We recorded an income tax benefit as a result of the reversal of the excess tax reserves related to this settlement. The aforementioned discrete income tax benefits reduced the effective tax rate by 10.4 percentage points in fiscal 2006. These tax benefits were partially offset by non-deductible MaxStream acquired in-process research and development expense, which increased the effective tax rate in fiscal 2006 by 4.6 percentage points (see reconciliation of the statutory income tax rate to the effective tax rate in Note 8 to our Consolidated Financial Statements).

The effective tax rates for fiscal 2008, 2007 and 2006 are lower than the U.S. statutory rate of 35.0% primarily due to the aforementioned income tax benefits and the utilization of income tax credits and exclusions for extraterritorial income in all years and the domestic production activities deduction in all years.

As of September 30, 2008, we have domestic tax credit carryforwards of \$0.2 million the majority of which will expire in 2013. We also have foreign tax credit carryforwards at September 30, 2008 of \$0.2 million, the majority of which will expire in 2013.

We are required to assess the realizability of our deferred tax assets and the need for a valuation allowance against those assets in accordance with Statement of Financial Accounting Standards No. 109 Accounting for Income Taxes (SFAS 109). We have concluded that it is more likely than not that the remaining deferred tax assets will be realized based on future projected taxable income and the anticipated future reversal of deferred tax liabilities, and therefore no valuation allowance has been established at September 30, 2008. The amount of the net deferred tax assets realized, however, could vary if there are differences in the timing or amount of future reversals of existing deferred tax liabilities or changes in the amounts of future taxable income. If our future taxable income projections are not realized, a valuation allowance would be required, and would be reflected as income tax expense at the time that any such change in future taxable income is determined.

**INFLATION**

Management believes that during fiscal years 2008, 2007 and 2006, inflation has not had a material effect on our operations or on our consolidated financial position.

**LIQUIDITY AND CAPITAL RESOURCES**

We have financed our operations principally with funds generated from operations. We had cash, cash equivalents and short-term marketable securities of \$73.5 million, \$85.5 million and \$58.9 million at September 30, 2008, 2007 and 2006, respectively. Our working capital was \$112.2 million, \$115.7 million and \$83.3 million at September 30, 2008, 2007 and 2006, respectively.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)****Consolidated Statement of Cash Flow Highlights (in thousands)**

|  | Year ended September 30, |           |           |
|--|--------------------------|-----------|-----------|
|  | 2008                     | 2007      | 2006      |
| Operating activities   | \$ 24,070                | \$ 26,379 | \$ 20,436 |
| Investing activities   | (22,370)                 | (28,715)  | (23,203)  |
| Financing activities   | (2,564)                  | 4,811     | 5,558     |
| Effect of exchange rate changes on cash and cash equivalents | (3,335)                  | 226       | (107)     |
| Net (decrease) increase in cash and cash equivalents         | \$ (4,199)               | \$ 2,701  | \$ 2,684  |

Net cash provided by operating activities was \$24.1 million during fiscal 2008 compared to \$26.4 million during fiscal 2007, a net decrease of \$2.3 million. This net decrease is primarily due to a decrease in net income of \$7.4 million, a decrease of \$1.5 million related to deferred income taxes, offset by \$1.0 million of other-than-temporary impairment on marketable securities during fiscal 2008, \$1.9 million of in-process research and development charges in fiscal 2008, \$1.1 million of other non-cash items and \$2.6 million of increases due to changes in working capital. Changes in working capital increased cash flows by \$2.6 million primarily due to increases resulting from changes in inventories, accounts payable and income taxes payable, partially offset by changes in accounts receivable and accrued expenses. Net cash provided by operating activities was \$26.4 million during fiscal 2007 compared to net cash provided by operating activities of \$20.4 million during fiscal 2006, a net increase of \$6.0 million. This net increase is primarily due to an increase of \$8.7 million of net income and a reduction of \$3.5 million for non-cash items, primarily related to deferred income taxes, in-process research and development charges and gain on sale of land during fiscal 2007, offset by increases primarily related to stock-based compensation and provisions for bad debts. Changes in working capital increased cash flows by \$0.8 million resulting from increases of \$2.4 million from changes in accounts receivable, income taxes payable, accounts payable and other accrued expenses offset by a reduction in cash flows of \$1.6 million due to inventories as additional material purchases and production builds were planned in order to fulfill order demand.

Net cash used in investing activities was \$22.4 million during fiscal 2008 compared to \$28.7 million and \$23.2 million used during fiscal 2007 and fiscal 2006, respectively. While net settlements from marketable securities were \$8.7 million in fiscal 2008, net purchases of marketable securities were \$26.0 million for fiscal 2007 and \$6.0 million for fiscal 2006. Proceeds from the sale of property and equipment amounted to \$6.9 million related to the sale of our building in Dortmund, Germany (see Note 11 to our Consolidated Financial Statements) and \$1.0 million during fiscal 2007, while purchases of property, equipment, improvements and certain other intangible assets were \$4.4 million, \$2.9 million and \$1.3 million for fiscal 2008, 2007 and 2006, respectively. During fiscal 2008, we paid a deposit of \$0.4 million for the Dortmund building leaseback. We also used \$1.3 million in fiscal 2008 and \$0.8 million in fiscal 2007 for contingent purchase price payments related to the acquisition of FS Forth. During fiscal 2008, we paid \$27.8 million (net of cash acquired of \$3.1 million) for the acquisition of Sarian and we paid \$4.0 million in cash for the acquisition of Spectrum. During fiscal 2006, we paid \$16.1 million in cash (net of cash acquired of \$3.7 million) for the acquisition of MaxStream. Proceeds from the sale of intellectual property were \$0.2 million in fiscal 2006.

Net cash used in financing activities was \$2.6 million in fiscal 2008 as \$5.1 million was used to repurchase treasury stock and \$0.4 million was used for capital lease obligations, partially offset by cash received from the exercise of stock options and employee stock purchase plan transactions of \$2.9 million. We also borrowed and repaid a \$25.0 million loan during the third quarter of fiscal 2008 to finance the Sarian acquisition. During fiscal 2007, we generated \$4.8 million from financing activities primarily due to \$5.2 million of cash received

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)**

from the exercise of stock options and employee stock purchase plan transactions. We used \$0.4 million for capital lease obligations. During fiscal 2006, we generated \$5.6 million from financing activities primarily due to \$6.1 million of cash received from the exercise of stock options and employee stock purchase plan transactions. This was offset by \$0.5 million of cash used for capital lease obligations. We entered into a \$5.0 million short-term loan agreement during the fourth quarter of fiscal 2006 to finance the MaxStream acquisition and repaid the loan in the same quarter.

Management believes that current financial resources, cash generated from operations and our potential capacity for debt and/or equity financing will be sufficient to fund our business operations for the next twelve months.

The following summarizes our contractual obligations at September 30, 2008:

| (in thousands)                     | Total     | Payments due by fiscal period |           |           |            |
|------------------------------------|-----------|-------------------------------|-----------|-----------|------------|
|                                    |           | Less than<br>1 year           | 1-3 years | 3-5 years | Thereafter |
| Operating leases                   | \$ 10,792 | \$ 3,064                      | \$ 4,376  | \$ 2,239  | \$ 1,113   |
| Capital leases                     | 392       | 324                           | 68        |           |            |
| Deferred payment on acquisition    | 5,575     |                               | 5,575     |           |            |
| Unrecognized tax benefits          | 3,652     | 465                           | 1,796     | 1,141     | 250        |
| Total contractual cash obligations | \$ 20,411 | \$ 3,853                      | \$ 11,815 | \$ 3,380  | \$ 1,363   |

The operating lease agreements included above relate to office space and equipment.

**FOREIGN CURRENCY**

We are exposed to foreign currency 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 hedging strategy to reduce foreign currency risk.

During 2008, we had approximately \$76.1 million of net sales related to foreign customers including export sales, of which \$45.7 million was denominated in foreign currency, predominately the Euro. During 2007 and 2006, we had approximately \$61.2 million and \$55.9 million, respectively, of net sales to foreign customers including export sales, of which \$30.1 million and \$23.3 million, respectively, were denominated in foreign currency, predominately the Euro. In future periods, a significant portion of sales will continue to be made in Euros and British Pounds.

During fiscal 2008, we acquired Sarian for \$30.5 million, which was partially financed by an intercompany loan from both Digi U.S. for \$25.0 million and Digi GmbH for \$2.9 million. We estimate that the Digi GmbH intercompany loan for \$2.9 million and \$2.0 million of the Digi U.S. \$25.0 million loan will be repaid in the foreseeable future and translation adjustments are recorded in the consolidated statements of operations. The remaining \$23.0 million of the Digi U.S. intercompany loan is not expected to be repaid in the foreseeable future. Accordingly, the translation adjustments related to \$23.0 million of the intercompany loan will be recorded in other comprehensive income within stockholders' equity on our consolidated balance sheet.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****RECENT ACCOUNTING DEVELOPMENTS**

In June 2008, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position Emerging Issues Task Force 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in FASB Statement No. 128, Earnings Per Share. This statement is effective for financial statements issued for fiscal years and interim periods within those years beginning after December 15, 2008 and will be applied retrospectively. We do not expect the adoption of FSP EITF 03-6-1 to have a material impact on our consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets ( FSP SFAS 142-3 ). FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets ( SFAS 142). FSP SFAS 142-3 intends to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flow used to measure the fair value of the asset under SFAS No. 141 (Revised 2007), Business Combinations and other accounting principles generally accepted in the United States. This statement is effective for financial statements issued for fiscal years and interim periods within those years beginning after December 15, 2008 and must be applied prospectively to intangible assets acquired after the effective date. We are currently evaluating the impact of FSP SFAS 142-3 on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations ( SFAS 141(R) ). This Statement retained the fundamental requirements in the former Statement that the acquisition method of accounting (previously referred to as the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defined the acquirer as the entity that obtains control of one or more businesses in the business combination and established the acquisition date as the date that the acquirer achieves control. The new standard requires the acquiring entity in a business combination to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. This Statement also makes certain other modifications to the former Statement. SFAS 141(R) is effective for business combinations that are consummated by us beginning October 1, 2009. Early adoption is not permitted. SFAS 141(R) is expected to have a material impact on how we will identify, negotiate, and value future acquisitions and how such acquisitions will affect our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ( SFAS 159 ). This Statement provides companies with an option to measure, at specified election dates, many financial instruments and certain other items at fair value that are not currently measured at fair value. A company that adopts SFAS 159 will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This Statement is effective for fiscal years beginning after November 15, 2007, which is our fiscal years beginning October 1, 2008. We do not expect SFAS 159 to have a material impact on our consolidated financial statements, if we decide to adopt it.

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**RECENT ACCOUNTING DEVELOPMENTS (CONTINUED)**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position No. 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement Under Statement 13 ( FSP 157-1 ) and FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 ( FSP 157-2 ). FSP 157-1 amends SFAS 157 to exclude various accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13, with the exception of assets or liabilities assumed in a business combination that are required to be measured at fair value under SFAS 141 or SFAS 141(R). In October 2008, the FASB issued FASB Staff Position No. 157-3 (FSP 157-3) which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-1 is effective upon the adoption of SFAS 157. FSP 157-2 defers the effective date of SFAS 157 to our fiscal years beginning October 1, 2009 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The provisions of SFAS 157 are effective for our fiscal years beginning October 1, 2008 for financial assets and financial liabilities. We are currently evaluating the impact of FSP 157-2 on our consolidated financial statements. We do not expect FSP 157-1 to have a material impact on our consolidated financial statements.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, the disclosure of contingent assets and liabilities and the values of purchased assets and assumed liabilities in acquisitions. We base our estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

**REVENUE RECOGNITION**

Our revenues are derived primarily from the sale of embedded and non-embedded products to our distributors and Direct (end-user) / OEM customers, and to a small extent from the sale of software licenses, fees associated with technical support, training, professional and engineering services, and royalties. We recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectibility is reasonably assured and there are no post-delivery obligations other than warranty.

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****CRITICAL ACCOUNTING POLICIES AND ESTIMATES (CONTINUED)****REVENUE RECOGNITION (CONTINUED)**

Under these criteria, product revenue is generally recognized upon shipment of product to customers. Sales to authorized domestic distributors and Direct / OEMs are made with certain rights of return and price adjustment provisions. Estimated reserves for future returns and pricing adjustments are established by us based on an analysis of historical patterns of returns and price adjustments as well as an analysis of authorized returns compared to received returns, current on-hand inventory at distributors, and distribution sales for the current period. Estimated reserves for future returns and price adjustments are charged against revenues in the same period as the corresponding sales are recorded. Material differences between the historical trends used to determine estimated reserves and actual returns and pricing adjustments could result in a material change to our consolidated results of operations or financial position. We have applied consistent methodologies for estimating reserves for future returns and pricing adjustments for all years presented. The reserve for future returns and pricing adjustments was \$1.4 million at September 30, 2008 and 2007.

We also generate revenue from the sale of software licenses, post-contract customer support, fees associated with technical support, training, professional and engineering services, and royalties. Revenue recognized resulting from such non-product sales represented 0.8% of net sales in fiscal 2008, 0.4% of net sales in fiscal 2007, and 1.3% of net sales in fiscal 2006. Our software development tools and development boards often include multiple elements, including hardware, software licenses, post-contract customer support, limited training and basic hardware design review. Our customers purchase these products and services during their product development process in which they use the tools to build network connectivity into the devices they are manufacturing. Revenue for software licenses, professional and engineering services and training is recognized upon performance, which includes delivery of a final product version and acceptance by the customer. For post-contract customer support and fees associated with technical support, revenue is deferred and recognized over the life of the contract as service is performed. Unearned post-contract customer support and unearned nonrecurring engineering services revenue is included in deferred revenue on the balance sheet.

**CASH EQUIVALENTS AND MARKETABLE SECURITIES**

We regularly monitor and evaluate the realizable value of our marketable securities to determine if an impairment exists in any of the securities. SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities (SFAS 115) defines an impairment as any security where the market value is below the cost basis on a security-by-security basis. We review the length of time the security was impaired, the significance of the impairment and market factors affecting the value of the security. For each impaired security, we then determine whether or not we believe the impairment was other-than-temporary. During the fourth quarter of fiscal 2008, we recorded an other-than-temporary impairment of \$1.0 million on a bond issued by Lehman Brothers with a par amount of \$1.2 million. This impairment reflects the estimated decline in the value of this security precipitated by the bankruptcy of the security's issuer. In addition, as of September 30, 2008 we have unrealized losses in our marketable securities of \$2.8 million that we determined are not other-than-temporarily impaired.

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 these 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 additional impairment charges for other securities in our investment portfolio. We will continue to monitor the fair value of securities and relevant market conditions and we will record additional impairment charges in the future if circumstances warrant such charges.

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES (CONTINUED)**

**ALLOWANCE FOR DOUBTFUL ACCOUNTS**

We maintain an allowance for doubtful accounts, which reflects the estimate of losses that may result from the inability of some of our customers to make required payments. The estimate for the allowance for doubtful accounts is based on known circumstances regarding collectability of customer accounts and historical collections experience. If the financial condition of one or more of our customers were to deteriorate, resulting in an inability to make payments, additional allowances may be required. Material differences between the historical trends used to estimate the allowance for doubtful accounts and actual collection experience could result in a material change to our consolidated results of operations or financial position. The allowance for doubtful accounts was \$0.7 million at September 30, 2008 and \$0.5 million at September 30, 2007.

**INVENTORY AND RESERVES**

Inventories are stated at the lower of cost or fair market value, with cost determined using the first-in, first-out method. We reduce the carrying value of our inventories for estimated excess and obsolete inventories equal to the difference between the cost of inventory and its estimated realizable value based upon assumptions about future product demand and market conditions. If actual product demand or market conditions are less favorable than those projected by management, additional inventory write-downs may be required that could result in a material change to our consolidated results of operations or financial position. We have applied consistent methodologies for the net realizable value of inventories. The reserve for excess and obsolete inventory was \$1.7 million and \$2.0 million at September 30, 2008 and 2007, respectively.

**IDENTIFIABLE INTANGIBLE ASSETS**

Purchased proven technology, customer relationships, license agreements, covenants not to compete and other identifiable intangible assets are recorded at fair value when acquired in a business acquisition, or at cost when not purchased in a business combination. Purchased in-process research and development costs (IPR&D) are expensed upon consummation of the related business acquisition. All other identifiable intangible assets are amortized on either a straight-line basis over their estimated useful lives of three to thirteen years or based on the pattern in which the asset is consumed. Useful lives for identifiable intangible assets are estimated at the time of acquisition based on the periods of time from which we expect to derive benefits from the identifiable intangible assets. Amortization of purchased and core technology is presented as a separate component of cost of sales in the Consolidated Statement of Operations. Amortization of all other acquired identifiable intangible assets is charged to operating expenses as a component of general and administrative expense.

In accordance with SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144), identifiable intangible assets are reviewed for impairment whenever events or circumstances indicate that the asset's undiscounted expected future cash flows are not sufficient to recover the carrying value amount. We measure impairment loss by utilizing an undiscounted cash flow valuation technique using fair values indicated by the income approach. Impairment losses, if any, would be recorded currently. To the extent that our undiscounted future cash flows were to decline substantially, such an impairment charge could result. No impairment was identified during fiscal 2008. There are certain assumptions inherent in projecting the recoverability of our identifiable intangible assets. If actual experience differs from the assumptions made, our consolidated results of operations or financial position could be materially impacted. We also periodically evaluate the appropriateness of the remaining useful lives of long-lived assets and the method of depreciation or amortization.

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES (CONTINUED)**

**GOODWILL**

Goodwill represents the excess of cost over the fair value of identifiable assets acquired and is not amortized.

However, in accordance with SFAS No. 142, goodwill is subject to an impairment assessment at least annually which may result in a charge to operations if the fair value of the reporting unit in which the goodwill is reported declines. There are certain assumptions inherent in projecting the fair value of goodwill. Significant assumptions include our estimates of future cash flows and the cost of capital. These and other estimates are based upon information that we use to prepare our annual and five year business plan projections. If actual experience differs from the assumptions made, our consolidated results of operations or financial position could be materially impacted.

We performed our annual goodwill impairment assessment as of June 30, 2008, on our one reporting unit. Based on our analysis, we conclude that the fair value of our reporting unit exceeds the carrying amount and therefore goodwill is not considered impaired. When the assessment was performed, our market capitalization, which is an indicator of fair value, was below the carrying value of our reporting unit due to significant declines in our stock price during the year. However, an estimated control premium was also used in our determination of fair value. The control premium represents the amount an investor would pay, over and above market capitalization, in order to obtain a controlling interest in a company. Therefore, the fair value of our reporting unit was measured using our market capitalization as of June 30, 2008, plus a control premium in a range of 20% to 30%. The estimated control premium was determined by a review of premiums paid for similar companies over the past five years. The control premium used in our determination of fair value is subject to management judgment, including the interpretation of current economic indicators and market valuations as well as our strategic plans with regard to our operations. To the extent additional information arises or our strategies change, it is possible that our conclusion regarding goodwill impairment could change, which could have a material effect on our financial position and results of operations. (See Note 3 to our Consolidated Financial Statements).

**INCOME TAXES**

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 could result in adjustments to our income tax balances that are material to our consolidated financial position and results of operations.

Effective October 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48). As a result of our adoption of FIN 48, we recognized an increase in our existing liabilities for unrecognized tax benefits of \$1.1 million and additional deferred tax assets of \$0.6 million, with an offsetting cumulative effect adjustment resulting in a decrease to the opening balance of retained earnings of \$0.5 million. At the adoption date, we had \$3.5 million of gross unrecognized tax benefits and accrued interest and penalties of \$0.5 million. In conjunction with our adoption of FIN 48, we reclassified \$4.0 million of unrecognized tax benefits to a long-term liability as we do not expect significant payments to occur over the next 12 months. If all of our unrecognized tax benefits were recognized, approximately \$3.7 million would impact our effective tax rate before the benefit recognized related to corresponding deferred tax assets. We recognize interest and penalties related to income tax matters in income tax expense. During the year ended September 30, 2008, we recognized \$0.2 million in interest and penalties. As of September 30, 2008, we have accrued \$0.7 million in interest and penalties on our consolidated balance sheet.



**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES (CONTINUED)**

**INCOME TAXES (CONTINUED)**

During fiscal 2008, we reversed \$0.3 million in income tax reserves primarily associated with the statutory closing of prior U.S. federal and state tax year. We recorded an additional \$0.2 million of discrete tax benefits as a result of a filing of a prior year tax return and adjustments to actual for items reported on the tax returns for fiscal 2007. During fiscal 2007, we reversed \$3.6 million in income tax reserves primarily associated with the closing of a German tax audit and the statutory closing of a prior U.S. federal and state tax year. We also recorded other discrete tax benefits of \$0.7 million related to the filing of U.S. amended tax returns, enactment of the extension of the research and development tax credit, and adjustments to actual for items reported on the tax returns filed for fiscal 2006. During fiscal 2006, we recorded discrete tax benefits of \$1.6 million, primarily related to the settlement of an audit with the French government of certain of our prior fiscal years income tax returns.

Certain open tax years are expected to close in future years that 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 2005 and 2004 in the case of U.S. federal and non-U.S. income tax authorities, respectively, and for tax years generally before fiscal 2004, in the case of state taxing authorities, consisting primarily of Minnesota and California.

The U.S. income tax credit for increased research and development expired on December 31, 2007. Accordingly, the fiscal year 2008 financial statements reflect the credit earned on activity through December 31, 2007. On October 3, 2008 the president signed the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 that retroactively extended the credit until December 31, 2009. The tax benefit of the extended credit earned on activity from January 1, 2008 to September 30, 2008 will be recorded in the first quarter of fiscal 2009.

At September 30, 2008, we have approximately \$5.2 million of accumulated undistributed earnings of controlled foreign subsidiaries that are considered to be reinvested indefinitely as of such date pursuant to paragraph 12 of Accounting Principles Board (APB) No. 23, Accounting for Income Taxes. Accordingly, no deferred tax has been provided on such earnings. If the applicable earnings were remitted to us, applicable U.S. federal tax would be substantially offset by available foreign tax credits.

Deferred tax assets and liabilities are recorded based on SFAS No. 109, Accounting for Income Taxes (SFAS 109). The amount of deferred tax assets and liabilities actually realized could be impacted by differences in the timing or amount of future reversals of existing deferred tax liabilities or changes in the amounts of future taxable income. If we determine that it is more likely than not that a deferred tax asset will not be realized, a valuation allowance would be required, and would be reflected as income tax expense at the time that any such change in estimated future taxable income is determined. We have determined that a valuation allowance is not required as of September 30, 2008.

**STOCK-BASED COMPENSATION**

Effective October 1, 2005, we adopted FASB Statement No. 123 (revised 2004), Share-Based Payment (SFAS 123R) which revises SFAS 123 and supersedes APB 25. This standard requires the recognition of the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. Under this statement, we must measure the cost of employee services received in exchange for an award of equity instruments based upon the fair value of the award on the date of grant. This cost must be recognized over the period during which an employee is required to provide the service (usually the vesting

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES (CONTINUED)**

**STOCK-BASED COMPENSATION (CONTINUED)**

period). For fiscal 2008, 2007 and 2006, stock-based compensation resulted in an increase in compensation expense of \$3.7 million, \$3.0 million and \$2.3 million, respectively. (See Note 9 to our Consolidated Financial Statements)

**SELF-INSURED LIABILITIES**

We are self-insured and retain a significant portion of the risk for certain losses related to health and dental liability claims. Liabilities associated with these losses include estimates of both claims filed and losses incurred but not yet reported. Through various methods, including data received from our health claims administrator and our analysis of historical trends, we estimate the costs of these risks. We believe the amounts accrued are adequate, although actual losses may differ from the amounts provided. We maintain stop-loss coverage to limit the exposure related to certain risks.

**WARRANTIES**

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 due 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 product warranty accrual was \$1.2 million for each of the years ended September 30, 2008 and 2007 and \$1.1 million for the year ended September 30, 2006.

**Table of Contents**

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**INTEREST RATE RISK**

Our exposure to interest rate risk relates primarily to our investment portfolio. We do not use derivative financial instruments to hedge against interest rate risk as all investments are currently held to maturity and the majority of our investments mature in less than a year.

**FOREIGN CURRENCY RISK**

We are exposed to foreign currency 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 hedging strategy to reduce foreign currency risk.

During 2008, the average monthly exchange rate for the Euro to the U.S. Dollar increased by approximately 13.0% from 1.3305 to 1.5038, the average monthly exchange rate for the British Pound to the U.S. Dollar increased approximately 0.2% from 1.9690 to 1.9730 and the average monthly exchange rate for the Japanese Yen to the U.S. Dollar increased by approximately 10.6% from .0084 to .0093. A 10.0% change from the 2008 average exchange rate for the Euro, British Pound and Yen to the U.S. Dollar would have resulted in a 1.6% increase or decrease in annual net sales and a 2.1% increase or decrease in stockholders' equity. The above analysis does not take into consideration any pricing adjustments we may need to consider in response to changes in the exchange rate.

**CREDIT RISK**

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

Investments are made in accordance with our investment policy and consist of commercial paper and corporate bonds. We may have some exposure related to the fair value of our securities, which could change significantly based on changes in market conditions and continued uncertainties in the credit markets. If these uncertainties continue or if these securities experience credit rating downgrades, we may incur additional impairment charges for other securities in our investment portfolio.

**Table of Contents****ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
TO THE STOCKHOLDERS AND BOARD OF DIRECTORS OF DIGI INTERNATIONAL INC.**

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of cash flows and of stockholders' equity and comprehensive income present fairly, in all material respects, the financial position of Digi International Inc. and its subsidiaries at September 30, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2008 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(1) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2008, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As described in Note 8 to the consolidated financial statements, the Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FIN 48) beginning October 1, 2007.

As discussed in Management's Report on Internal Control over Financial Reporting, management has excluded Sarian Systems, Ltd. from its assessment of internal control over financial reporting as of September 30, 2008 because it was acquired by the Company in a purchase business combination during fiscal year 2008. We have also excluded Sarian Systems, Ltd. from our audit of internal control over financial reporting. Sarian Systems, Ltd. is a wholly-owned subsidiary whose assets and total revenues represent 2.4% and 3.1%, respectively, of the related consolidated financial statement amounts as of and for the year ended September 30, 2008.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company

**Table of Contents**

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM (CONTINUED)**

are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Minneapolis, Minnesota

November 25, 2008

**Table of Contents****ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA (CONTINUED)****DIGI INTERNATIONAL INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per common share data)

| For the fiscal years ended September 30,  | 2008       | 2007       | 2006       |
|---|------------|------------|------------|
| Net sales   | \$ 185,056 | \$ 173,263 | \$ 144,663 |
| Cost of sales (exclusive of amortization of purchased and core technology shown separately below) | 83,096     | 77,376     | 62,322     |
| Amortization of purchased and core technology   | 4,091      | 4,541      | 4,836      |
| Gross profit  | 97,869     | 91,346     | 77,505     |
| Operating expenses:   |            |            |            |
| Sales and marketing   | 36,879     | 33,499     | 28,591     |
| Research and development  | 27,040     | 24,176     | 20,861     |
| General and administrative  | 16,035     | 13,343     | 12,830     |
| Acquired in-process research & development  | 1,900      |            | 2,000      |
| Total operating expenses  | 81,854     | 71,018     | 64,282     |
| Operating income  | 16,015     | 20,328     | 13,223     |
| Other income (expense):   |            |            |            |
| Interest income   | 3,579      | 3,482      | 2,426      |
| Interest expense  | (174)      | (86)       | (213)      |
| Impairment of marketable security   | (1,015)    |            |            |
| Other income (expense)  | 510        |            | (169)      |
| Total other income, net   | 2,900      | 3,396      | 2,044      |
| Income before income taxes  | 18,915     | 23,724     | 15,267     |
| Income tax provision  | 6,564      | 3,951      | 4,154      |
| Net income  | \$ 12,351  | \$ 19,773  | \$ 11,113  |
| Net income per common share:  |            |            |            |
| Basic   | \$ 0.48    | \$ 0.78    | \$ 0.48    |
| Diluted   | \$ 0.47    | \$ 0.76    | \$ 0.46    |
| Weighted average common shares, basic   | 25,659     | 25,259     | 23,338     |
| Weighted average common shares, diluted   | 26,242     | 26,121     | 24,080     |

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

**Table of Contents****ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA (CONTINUED)****DIGI INTERNATIONAL INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

| As of September 30,                               | 2008       | 2007       |
|---|------------|------------|
| <b>ASSETS</b>                                     |            |            |
| Current assets:                                   |            |            |
| Cash and cash equivalents                         | \$ 14,176  | \$ 18,375  |
| Marketable securities                             | 59,337     | 67,111     |
| Accounts receivable, net                          | 24,310     | 21,022     |
| Inventories                                       | 30,240     | 26,130     |
| Deferred tax assets                               | 2,100      | 2,096      |
| Other   | 3,006      | 2,865      |
| Total current assets                              | 133,169    | 137,599    |
| Marketable securities                             | 179        | 2,081      |
| Property, equipment and improvements, net         | 16,255     | 19,987     |
| Identifiable intangible assets, net               | 34,032     | 24,214     |
| Goodwill  | 86,578     | 66,817     |
| Deferred tax assets                               | 553        | 705        |
| Other   | 650        | 423        |
| Total assets                                      | \$ 271,416 | \$ 251,826 |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>        |            |            |
| Current liabilities:                              |            |            |
| Capital lease obligations, current portion        | \$ 267     | \$ 379     |
| Accounts payable                                  | 10,343     | 6,554      |
| Income taxes payable                              | 182        | 3,156      |
| Accrued expenses:                                 |            |            |
| Compensation                                      | 5,981      | 7,080      |
| Warranty  | 1,214      | 1,155      |
| Other   | 2,593      | 3,382      |
| Deferred revenue                                  | 353        | 190        |
| Total current liabilities                         | 20,933     | 21,896     |
| Capital lease obligations, net of current portion | 78         | 358        |
| Deferred tax liabilities                          | 7,582      | 6,667      |
| Income taxes payable                              | 4,358      |            |
| Deferred payment on acquisition                   | 5,575      |            |
| Deferred gain on building sale leaseback          | 956        |            |
| Total liabilities                                 | 39,482     | 28,921     |

Commitments and contingencies

Edgar Filing: DIGI INTERNATIONAL INC - Form 10-K

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; 28,335,876 and 28,153,763 shares issued | 283            | 281            |
| Additional paid-in capital   | 177,614        | 172,156        |
| Retained earnings  | 78,625         | 66,782         |
| Accumulated other comprehensive (loss) income  | (1,897)        | 2,121          |
| Treasury stock, at cost, 2,960,457 and 2,606,419 shares  | (22,691)       | (18,435)       |
| <br>Total stockholders' equity   | <br>231,934    | <br>222,905    |
| <br>Total liabilities and stockholders' equity   | <br>\$ 271,416 | <br>\$ 251,826 |

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



**Table of Contents****ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA (CONTINUED)****DIGI INTERNATIONAL INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

| For the fiscal years ended September 30,  | 2008      | 2007      | 2006      |
|---|-----------|-----------|-----------|
| Operating activities:   |           |           |           |
| Net income  | \$ 12,351 | \$ 19,773 | \$ 11,113 |
| Adjustments to reconcile net income to net cash provided by operating activities: |           |           |           |
| Depreciation of property, equipment and improvements                              | 2,488     | 2,453     | 2,711     |
| Amortization of identifiable intangible assets and other assets                   | 6,830     | 7,712     | 7,855     |
| Bad debt provision and (product return recoveries)                                | 308       | (93)      | (368)     |
| Gain on sale of intellectual property   |           |           | (247)     |
| Provision for inventory obsolescence  | 536       | 369       | 542       |
| Excess tax benefits from stock-based compensation                                 | (184)     | (621)     | (726)     |
| Impairment on marketable security   | 1,015     |           |           |
| Stock-based compensation  | 3,697     | 3,025     | 2,289     |
| Deferred income taxes   | (1,624)   | (115)     | 1,700     |
| Acquired in-process research & development  | 1,900     |           | 2,000     |
| (Gain) loss on sale of property and equipment                                     | (3)       | (427)     | 82        |
| Amortization of deferred gain on building sale                                    | (142)     |           |           |
| Changes in operating assets and liabilities (net of acquisitions):                |           |           |           |
| Accounts receivable   | (1,838)   | (142)     | (818)     |
| Inventories   | (3,093)   | (4,448)   | (2,883)   |
| Other assets  | 96        | 125       | (195)     |
| Income taxes payable  | 7         | (270)     | (631)     |
| Accounts payable  | 3,322     | (508)     | (1,174)   |
| Accrued expenses  | (1,596)   | (454)     | (814)     |
| Net cash provided by operating activities   | \$ 24,070 | \$ 26,379 | \$ 20,436 |
| Investing activities:   |           |           |           |
| Purchase of held-to-maturity marketable securities                                | (69,196)  | (92,742)  | (48,881)  |
| Proceeds from maturities of held-to-maturity marketable securities                | 77,857    | 66,757    | 42,858    |
| Proceeds from sale of intellectual property                                       |           |           | 247       |
| Proceeds from sale of property and equipment                                      | 6,954     | 950       |           |
| Purchase of property, equipment, improvements and certain other intangible assets | (4,425)   | (2,899)   | (1,331)   |
| Increase in restricted cash non-current   | (392)     |           |           |
| Contingent purchase price payments related to FS Forth-Systeme GmbH               | (1,315)   | (781)     |           |
| Acquisition of businesses, net of cash acquired                                   | (31,853)  |           | (16,096)  |
| Net cash used in investing activities   | (22,370)  | (28,715)  | (23,203)  |
| Financing activities:   |           |           |           |
| Payments on capital lease obligations   | (361)     | (369)     | (490)     |
| Borrowing on note payable   | 25,000    |           | 5,000     |

Edgar Filing: DIGI INTERNATIONAL INC - Form 10-K

|   |           |           |           |
|---|-----------|-----------|-----------|
| Payment on note payable   | (25,000)  |           | (5,000)   |
| Purchase of treasury stock  | (5,104)   |           |           |
| Proceeds from stock option plan transactions                        | 1,699     | 3,389     | 4,558     |
| Proceeds from employee stock purchase plan transactions             | 1,018     | 1,170     | 764       |
| Excess tax benefits from stock-based compensation                   | 184       | 621       | 726       |
| Net cash (used) provided by financing activities                    | (2,564)   | 4,811     | 5,558     |
| Effect of exchange rates changes on cash and cash equivalents       | (3,335)   | 226       | (107)     |
| Net (decrease) increase in cash and cash equivalents                | (4,199)   | 2,701     | 2,684     |
| Cash and cash equivalents, beginning of period                      | 18,375    | 15,674    | 12,990    |
| Cash and cash equivalents, end of period                            | \$ 14,176 | \$ 18,375 | \$ 15,674 |
| Supplemental Cash Flows Information:                                |           |           |           |
| Interest paid   | \$ 136    | \$ 86     | \$ 213    |
| Income taxes paid, net  | \$ 8,143  | \$ 4,072  | \$ 2,871  |
| Other non-cash financing and investing items:                       |           |           |           |
| Deferred payment liability related to acquisition                   | \$ 5,537  | \$        | \$        |
| Equipment acquired under capital lease                              | \$ 9      | \$        | \$        |
| Accrual for FS Forth-Systeme GmbH contingent purchase price payment | \$        | \$ 950    | \$ 800    |
| Issuance of common stock for MaxStream acquisition                  | \$        | \$        | \$ 20,704 |

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

**Table of Contents****ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA (CONTINUED)****DIGI INTERNATIONAL INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME**

(in thousands)

For the years ended September 30, 2008, 2007 and 2006

|   | Common Stock |           | Treasury Stock |            | Additional      | Retained  | Accumulated                | Total               |
|---|--------------|-----------|----------------|------------|-----------------|-----------|----------------------------|---------------------|
|   | Shares       | Par Value | Shares         | Value      | Paid-In Capital | Earnings  | Other Comprehensive Income | Stockholders Equity |
| Balances, September 30, 2005                        | 25,457       | \$ 255    | 2,795          | \$(19,766) | \$ 136,513      | \$ 35,896 | \$ 639                     | \$ 153,537          |
| Net income  |              |           |                |            |                 | 11,113    |                            | 11,113              |
| Foreign currency translation adjustment             |              |           |                |            |                 |           | 301                        | 301                 |
| Total comprehensive income                          |              |           |                |            |                 |           |                            | 11,414              |
| Employee stock purchase issuances                   |              |           | (83)           | 588        | 176             |           |                            | 764                 |
| Issuance of stock upon exercise of stock options    | 615          | 6         |                |            | 4,552           |           |                            | 4,558               |
| Tax benefit realized upon exercise of stock options |              |           |                |            | 564             |           |                            | 564                 |
| Stock-based compensation expense                    |              |           |                |            | 2,289           |           |                            | 2,289               |
| Issuance of stock MaxStream acquisition             | 1,677        | 16        |                |            | 20,688          |           |                            | 20,704              |
| Balances, September 30, 2006                        | 27,749       | 277       | 2,712          | (19,178)   | 164,782         | 47,009    | 940                        | 193,830             |
| Net income  |              |           |                |            |                 | 19,773    |                            | 19,773              |
| Foreign currency translation                        |              |           |                |            |                 |           | 1,181                      | 1,181               |

adjustment

|   |        |     |       |          |         |        |         |    |         |
|---|--------|-----|-------|----------|---------|--------|---------|----|---------|
| Total comprehensive income                          |        |     |       |          |         |        |         |    | 20,954  |
| Employee stock purchase issuances                   |        |     | (106) | 743      | 427     |        |         |    | 1,170   |
| Issuance of stock upon exercise of stock options    | 405    | 4   |       |          | 3,385   |        |         |    | 3,389   |
| Tax benefit realized upon exercise of stock options |        |     |       |          | 537     |        |         |    | 537     |
| Stock-based compensation expense                    |        |     |       |          | 3,025   |        |         |    | 3,025   |
| Balances, September 30, 2007                        | 28,154 | 281 | 2,606 | (18,435) | 172,156 | 66,782 | 2,121   | \$ | 222,905 |
| Net income  |        |     |       |          |         | 12,351 |         |    | 12,351  |
| Foreign currency translation adjustment             |        |     |       |          |         |        | (4,018) |    | (4,018) |
| Total comprehensive income                          |        |     |       |          |         |        |         |    | 8,333   |
| Cumulative effect from adoption of FIN 48           |        |     |       |          |         | (508)  |         |    | (508)   |
| Employee stock purchase issuances                   |        |     | (117) | 848      | 170     |        |         |    | 1,018   |
| Purchase of treasury stock                          |        |     | 471   | (5,104)  |         |        |         |    | (5,104) |
| Issuance of stock upon exercise of stock options    | 182    | 2   |       |          | 1,697   |        |         |    | 1,699   |
| Tax benefit realized upon exercise of stock options |        |     |       |          | (106)   |        |         |    | (106)   |
| Stock-based compensation                            |        |     |       |          | 3,697   |        |         |    | 3,697   |

expense

Balances,  
September 30,  
2008

|        |    |     |       |            |            |           |    |         |    |         |
|--------|----|-----|-------|------------|------------|-----------|----|---------|----|---------|
| 28,336 | \$ | 283 | 2,960 | \$(22,691) | \$ 177,614 | \$ 78,625 | \$ | (1,897) | \$ | 231,934 |
|--------|----|-----|-------|------------|------------|-----------|----|---------|----|---------|

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

51

---

**Table of Contents**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**BUSINESS DESCRIPTION**

We are a worldwide leader in device networking for business, developing reliable products and technologies to connect and securely manage local or remote electronic devices over a network or via the Internet. Businesses use our products to create, customize and control retail operations, industrial automation and other applications.

Our products are sold globally through distributors, systems integrators, solution providers and direct marketers as well as direct to strategic OEMs, government and commercial partners.

**PRINCIPLES OF CONSOLIDATION**

The consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**CASH EQUIVALENTS**

Cash equivalents consist of money market accounts and other highly liquid investments purchased with an original maturity of three months or less. The carrying amounts approximate fair value due to the short maturities of these investments.

**MARKETABLE SECURITIES**

Marketable securities consist of commercial paper, corporate bonds and government municipal bonds. All marketable securities are classified as held-to-maturity and are carried at amortized cost. We estimate the fair value of our securities based upon many factors, including the use of quoted market prices on the secondary trading market, valuation techniques and understanding of the financial solvency of the security issuers.

We regularly monitor and evaluate the realizable value of our marketable securities. When assessing marketable securities for other-than-temporary declines in value, we consider factors including how significant the decline in value is as a percentage of the original cost, how long the market value of the investment has been less than its original cost, the underlying factors contributing to a decline in the prices of securities in a single asset class, the performance of the issuer's stock price in relation to the stock price of its competitors within the industry, expected market volatility, analyst recommendations, the views of external investment managers, any news or financial information that has been released specific to the investee and the outlook for the overall industry in which the issuer operates. If events and circumstances indicate that a decline in the value of these securities has occurred and is other-than-temporary, we would record a charge to other income (expense). As described in Note 12, we hold one security that is other-than-temporarily impaired.

**ACCOUNTS RECEIVABLE**

Accounts receivable are stated at the amount we expect to collect, which is net of an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The following factors are considered when determining the collectibility of specific customer accounts: customer creditworthiness, past transaction history with the customer, and changes in customer payment terms or practices. In addition, overall historical collection experience, current economic industry trends, and a review of the current status of trade accounts receivable are considered when determining the required allowance for doubtful accounts. Based on our assessment, we provide for estimated uncollectible amounts through a charge to earnings and a credit to valuation allowance.

Balances that remain outstanding after we have used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable.

**Table of Contents**

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

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**INVENTORIES**

Inventories are stated at the lower of cost or fair market value, with cost determined using the first-in, first-out method. Appropriate consideration is given to deterioration, obsolescence and other factors in evaluating fair market value.

**PROPERTY, EQUIPMENT AND IMPROVEMENTS**

Property, equipment and improvements are carried at cost, net of accumulated depreciation. Depreciation is provided by charges to operations using the straight-line method over the estimated asset useful lives. Furniture and fixtures and other equipment are depreciated over a period of three to five years. Building improvements and buildings are depreciated over ten and thirty-nine years, respectively. Equipment under capital lease is depreciated over the lease term. We own and occupy two buildings located in Minnetonka and Eden Prairie, Minnesota. During fiscal 2008, we sold our building in Dortmund, Germany and we are currently leasing back approximately 40% of the space over a period of five years.

Expenditures for maintenance and repairs are charged to operations as incurred, while major renewals and betterments are capitalized. The assets and related accumulated depreciation accounts are adjusted for asset retirements and disposals with the resulting gain or loss included in operations.

**IDENTIFIABLE INTANGIBLE ASSETS**

Purchased proven technology, license agreements, covenants not to compete and other identifiable intangible assets are recorded at fair value when acquired in a business acquisition, or at cost when not purchased in a business acquisition. Purchased in-process research and development costs (IPR&D) are expensed upon consummation of the related business acquisition. All other identifiable intangible assets are amortized on either a straight-line basis over their estimated useful lives of three to thirteen years or based on the pattern in which the asset is consumed. Useful lives for identifiable intangible assets are estimated at the time of acquisition based on the periods of time from which we expect to derive benefits from the identifiable intangible assets. Amortization of purchased and core technology is presented as a separate component of cost of sales in the Consolidated Statement of Operations. Amortization of all other acquired identifiable intangible assets is charged to operating expense as a component of general and administrative expense.

In accordance with SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144), identifiable intangible assets are reviewed for impairment whenever events or circumstances indicate that undiscounted expected future cash flows are not sufficient to recover the carrying value amount. We measure impairment loss by utilizing an undiscounted cash flow valuation technique using fair values indicated by the income approach. Impairment losses, if any, would be recorded in the current period. No impairments were identified during fiscal 2008, 2007 or 2006.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****GOODWILL**

Goodwill represents the excess of cost over the fair value of identifiable assets acquired. Goodwill is subject to an impairment assessment, using a discounted cash flow technique by reporting unit, at least annually which may result in a charge to operations if the fair value of the reporting unit in which the goodwill is reported declines.

We performed our annual goodwill impairment assessment as of June 30, 2008. Based on our analysis, we conclude that the fair value of our reporting unit exceeds the carrying amount and therefore goodwill is not considered impaired. When the assessment was performed, our market capitalization, which is an indicator of fair value, was below the carrying value of our reporting unit due to significant declines in our stock price during the year. However, an estimated control premium was also used in our determination of fair value. The control premium represents the amount an investor would pay, over and above market capitalization, in order to obtain a controlling interest in a company. Therefore, the fair value of our reporting unit was measured using our market capitalization as of June 30, 2008, plus a control premium.

The estimated control premium was determined by a review of premiums paid for similar companies over the past five years. The control premium used in our determination of fair value is subject to management judgment, including the interpretation of current economic indicators and market valuations as well as our strategic plans with regard to our operations. To the extent additional information arises or our strategies change, it is possible that our conclusion regarding goodwill impairment could change, which could have a material effect on our financial position and results of operations (see Note 3). As of September 30, 2008, our market capitalization exceeded our carrying value.

We also performed our annual goodwill impairment assessment as of June 30, 2007 and 2006 for our one reporting unit. Since the calculated fair value of the reporting unit exceeded book value at each of these dates, there was no impairment identified in those years.

**REVENUE RECOGNITION**

We recognize revenue in accordance with Staff Accounting Bulletin No. 104 Revenue Recognition in Financial Statements (SAB 104), Statement of Financial Accounting Standards No. 48 Revenue Recognition when the Right of Return Exists (SFAS 48), Statement of Position No. 97-2 Software Revenue Recognition (SOP 97-2), as amended by SOP 98-4 Deferral of the Effective Date of Certain Provisions of SOP No. 97-2, SOP 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts, and Emerging Issues Task Force (EITF) 00-21 Revenue Arrangements with Multiple Deliverables.

Revenue recognized for product sales was 99.2% of net sales in fiscal 2008, 99.6% of net sales in fiscal 2007 and 98.7% in fiscal 2006. We recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectibility is reasonably assured and there are no post-delivery obligations, other than warranty. Under these criteria, product revenue is generally recognized upon shipment of product to customers, including Direct (end-user) / OEMs and distributors. Sales to authorized domestic distributors and Direct / OEMs are made with certain rights of return and price adjustment provisions. Estimated reserves for future returns and pricing adjustments are established by us based on an analysis of historical patterns of returns and price adjustments as well as an analysis of authorized returns compared to received returns, current on-hand inventory at distributors, and distribution sales for the current period. Estimated reserves for future returns and price adjustments are charged against revenues in the same period as the corresponding sales are recorded.



**Table of Contents**

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

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**REVENUE RECOGNITION (CONTINUED)**

We also generate revenue from the sale of software licenses, post-contract customer support, fees associated with technical support, training, professional and engineering services, and royalties. Revenue recognized resulting from such non-product sales represented 0.8% of net sales in fiscal 2008, 0.4% of net sales in fiscal 2007, and 1.3% of net sales in fiscal 2006. Our software development tools and development boards often include multiple elements, including hardware, software licenses, post-contract customer support, limited training and basic hardware design review. Our customers purchase these products and services during their product development process in which they use the tools to build network connectivity into the devices they are manufacturing. Revenue for software licenses, professional and engineering services and training is recognized upon performance, which includes delivery of a final product version and acceptance by the customer. For post-contract customer support and fees associated with technical support, revenue is deferred and recognized over the life of the contract as service is performed. Royalty revenue is recognized when cash is received from the customer. Unearned post-contract customer support and unearned nonrecurring engineering services revenue is included in deferred revenue on the balance sheet.

**RESEARCH AND DEVELOPMENT**

Research and development costs are expensed when incurred. Research and development costs include compensation, allocation of corporate costs, depreciation, utilities, professional services and prototypes. Software development costs are expensed as incurred until the point that technological feasibility and proven marketability of the product are established. To date, the time period between the establishment of technological feasibility and completion of software development has been short, and no significant development costs have been incurred during that period. Accordingly, we have not capitalized any software development costs to date.

**INCOME TAXES**

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax basis of assets and liabilities and their financial reporting amounts at each year end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Income tax expense is equal to the tax payable for the period and the change during the period in deferred tax assets and liabilities.

**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 common equivalent shares outstanding during the period. Our only potentially dilutive common shares are those that result from dilutive common stock options and shares purchased through the employee stock purchase plan.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****NET INCOME PER COMMON SHARE (CONTINUED)**

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

| Years ended September 30,   | 2008      | 2007      | 2006      |
|---|-----------|-----------|-----------|
| Numerator:  |           |           |           |
| Net income  | \$ 12,351 | \$ 19,773 | \$ 11,113 |
| Denominator:  |           |           |           |
| Denominator for basic net income per common share weighted average shares outstanding | 25,659    | 25,259    | 23,328    |
| Effect of dilutive securities:  |           |           |           |
| Employee stock options and employee stock purchase plan                               | 583       | 862       | 742       |
| Denominator for diluted net income per common share adjusted weighted average shares  | \$ 26,242 | \$ 26,121 | \$ 24,080 |
| Basic net income per common share   | \$ 0.48   | \$ 0.78   | \$ 0.48   |
| Diluted net income per common share   | \$ 0.47   | \$ 0.76   | \$ 0.46   |

We use the treasury stock method to calculate the weighted-average shares used in the diluted earnings per share computation. Under the treasury stock method, the exercise price of an option, the amount of compensation cost, if any, for future service that we have not yet recognized, and the amount of estimated tax benefits that would be recorded in paid-in capital, if any, when the option is exercised are assumed to be used to repurchase shares in the current period.

Stock options to purchase 2,336,693, 573,134 and 1,327,000 common shares at September 30, 2008, 2007 and 2006, respectively, were not included in the computation of diluted earnings per common share because the options' exercise prices were greater than the average market price of common shares and, therefore, their effect would be antidilutive whether or not we generate net income.

**STOCK-BASED COMPENSATION**

Effective October 1, 2005, we adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), as amended by FASB Staff Position No. SFAS 123(R)-4, using the modified prospective method of application. This standard requires the recognition of the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. Under this statement, we must measure the cost of employee services received in exchange for an award of equity instruments based upon the fair value of the award on the date of grant. This cost must be recognized over the period during which an employee is required to provide the service (usually the vesting period).

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****FOREIGN CURRENCY TRANSLATION**

Financial position and results of operations of our international subsidiaries are measured using local currencies as the functional currency. Assets and liabilities of these operations are translated at the exchange rates in effect at each fiscal year-end. Statements of operations accounts are translated at the weighted average rates of exchange prevailing during the year. Translation adjustments arising from the use of differing exchange rates from period to period are included in accumulated other comprehensive income (loss) in stockholders' equity. Gains and losses on foreign currency exchange transactions are reflected in the statement of operations. Net transaction gains of \$0.5 million were recorded to other income (expense) for fiscal 2008. Net transaction gains and losses credited or expensed to general and administrative expenses for fiscal years 2007 and 2006 were immaterial. We have not implemented a hedging strategy to reduce the risk of foreign currency translation exposures.

**USE OF ESTIMATES AND RISKS AND UNCERTAINTIES**

The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**COMPREHENSIVE INCOME**

Our comprehensive income is comprised of net income and foreign currency translation adjustments, which are charged or credited to the accumulated other comprehensive income account in stockholders' equity.

**RECENT ACCOUNTING DEVELOPMENTS**

In June 2008, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position Emerging Issues Task Force 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in FASB Statement No. 128, Earnings Per Share. This statement is effective for financial statements issued for fiscal years and interim periods within those years beginning after December 15, 2008 and will be applied retrospectively. We do not expect the adoption of FSP EITF 03-6-1 to have a material impact on our consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets ( FSP SFAS 142-3 ). FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets ( SFAS 142). FSP SFAS 142-3 intends to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flow used to measure the fair value of the asset under SFAS No. 141 (Revised 2007), Business Combinations and other accounting principles generally accepted in the United States. This statement is effective for financial statements issued for fiscal years and interim periods within those years beginning after December 15, 2008 and must be applied prospectively to intangible assets acquired after the effective date. We are currently evaluating the impact of FSP SFAS 142-3 on our consolidated financial statements.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****RECENT ACCOUNTING DEVELOPMENTS (CONTINUED)**

In December 2007, the FASB issued SFAS 141(R), *Business Combinations* ( SFAS 141(R) ). This Statement retained the fundamental requirements in the former Statement that the acquisition method of accounting (previously referred to as the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defined the acquirer as the entity that obtains control of one or more businesses in the business combination and established the acquisition date as the date that the acquirer achieves control. The new standard requires the acquiring entity in a business combination to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. This Statement also makes certain other modifications to the former Statement. SFAS 141(R) is effective for business combinations that are consummated by us beginning October 1, 2009. Early adoption is not permitted. SFAS 141(R) is expected to have a material impact on how we will identify, negotiate, and value future acquisitions and how such acquisitions will affect our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* ( SFAS 159 ). This Statement provides companies with an option to measure, at specified election dates, many financial instruments and certain other items at fair value that are not currently measured at fair value. A company that adopts SFAS 159 will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This Statement is effective for fiscal years beginning after November 15, 2007, which is our fiscal years beginning October 1, 2008. We do not expect SFAS 159 to have a material impact on our consolidated financial statements, if we decide to adopt it.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position No. 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement Under Statement 13* ( FSP 157-1 ) and FASB Staff Position No. 157-2, *Effective Date of FASB Statement No. 157* ( FSP 157-2 ). FSP 157-1 amends SFAS 157 to exclude various accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13, with the exception of assets or liabilities assumed in a business combination that are required to be measured at fair value under SFAS 141 or SFAS 141(R). In October 2008, the FASB issued FASB Staff Position No. 157-3 (FSP 157-3) which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-1 is effective upon the adoption of SFAS 157. FSP 157-2 defers the effective date of SFAS 157 to our fiscal years beginning October 1, 2009 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The provisions of SFAS 157 are effective for our fiscal years beginning October 1, 2008 for financial assets and financial liabilities. We are currently evaluating the impact of FSP 157-2 on our consolidated financial statements. We do not expect FSP 157-1 to have a material impact on our consolidated financial statements.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****2. ACQUISITIONS****Sarian Systems, Ltd.**

On April 28, 2008, we acquired Sarian Systems, Ltd. ( Sarian ), which is now a wholly owned subsidiary of Digi International Ltd. Prior to the acquisition, Sarian was a privately held corporation located in the United Kingdom. The total purchase price of \$30.9 million, net of \$3.1 million of cash acquired, was for all of the outstanding ordinary shares of Sarian.

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation resulted in non-deductible goodwill of \$15.4 million and a charge of \$1.9 million for acquired in-process research and development. We believe that the acquisition resulted in the recognition of goodwill primarily because Sarian's wireless IP-based routing capability is highly complementary to our market approach and significantly expands our wireless offering.

Sarian's operating results are included in our consolidated results of operations from the date of acquisition. The consolidated balance sheet as of September 30, 2008 reflects the allocation of the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The table below sets forth the final purchase price allocation (in thousands):

|  |           |
|--|-----------|
| Cash, including direct acquisition costs                     | \$ 30,920 |
| Fair value of net tangible assets acquired                   | \$ 4,055  |
| Identifiable intangible assets:                              |           |
| Existing purchased and core technology                       | 7,800     |
| Existing customer relationships                              | 4,800     |
| Trade names  | 340       |
| Non-compete agreements                                       | 300       |
| In-process research and development                          | 1,900     |
| Goodwill   | 15,432    |
| Deferred tax liabilities related to identifiable intangibles | (3,707)   |
|  | \$ 30,920 |

The weighted average useful life for all the identifiable intangibles listed above is 7.1 years. The weighted average useful life for each intangible asset class is as follows: purchased and core technology 4.7 years, customer relationships 11.0 years, trade names 8.5 years, and non-compete agreements 3.0 years.

Useful lives for identifiable intangible assets are estimated at the time of acquisition based on the periods of time from which we expect to derive benefits from the identifiable intangible assets. The identifiable intangible assets, other than customer relationships, are amortized using the straight-line method which reflects the pattern at which the asset is consumed. Customer relationships are amortized based upon an accelerated method following estimated cash flows generated from the intangible asset, whereby more of the amortization is taken in the early years rather than later years. We do not expect the above intangible assets to have any significant residual value once they become fully amortized.

At the time of acquisition, Sarian had development projects in process associated with the IPV6, Gate Array and VPN technologies. We estimated that \$1.9 million of the purchase price represented the fair value of acquired in-process research and development related to the products listed below (in thousands):

|                  |          |
|------------------|----------|
| IPV6             | \$ 1,300 |
| Gate Array       | 400      |
| VPN technologies | 200      |

Total in-process research and development

\$ 1,900

59

---

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****2. ACQUISITIONS (CONTINUED)**

These products were under development, had a measurable percentage completed and a documented expected life, had not yet reached technological feasibility, and had no alternative future uses. This amount was expensed as a non-tax-deductible charge upon consummation of the acquisition.

We utilized the excess earnings method, a variation of the income approach, to determine the estimated fair value of the acquired in-process research and development. The estimated values are based upon the future cash flows to be generated by these in-process research and development projects over the projected period. These estimates were based on the following assumptions:

The estimated revenues were based upon our estimate of revenue growth for each of the products over the next ten fiscal years, using the assumption that all revenue recorded after the ten year period will be generated from future technologies.

The estimated operating expenses were based on consideration of historical selling, general and administrative expenses as a percentage of sales and Sarian's projected operating expenses.

Maintenance research and development, defined as the research and development necessary to sustain the existing technology and its revenue stream, was also included as an operating expense. The estimated remaining cost to complete each in-process research and development technology was also included in operating expenses.

When applying the excess earnings method, the cash flows expected to be generated by an asset are discounted to their present value equivalent using a rate of return that reflects the relative risk of the investment, as well as the time value of money. This return, known as the weighted average cost of capital ( WACC ), is an overall rate based upon the individual rates of return for invested capital (equity and interest-bearing debt). The discount rate used in the excess earnings method was 35%. Premiums were added to the WACC to account for the inherent risks in the development of the products, the risks of the products being completed on schedule, and the risk of the eventual sales of the product meeting the expectations of the Company. We used a 35% rate of return for the in-process research and development projects.

We anticipate that all the projects will be completed by the end of calendar year 2008 and are expected to start generating revenues beginning in calendar year 2009. The estimates described above are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur.

The following unaudited pro forma condensed consolidated results of operations have been prepared as if the acquisition of Sarian had occurred as of the beginning of each of the periods presented (in thousands, except per common share amounts). Pro forma adjustments include in each year, amortization of identifiable intangible assets and the \$1.9 million charge related to acquired in-process research and development associated with the Sarian acquisition.

|                                      | Year ended September 30, |           |
|--------------------------------------|--------------------------|-----------|
|                                      | 2008                     | 2007      |
| Net sales                            | \$192,734                | \$183,905 |
| Net income                           | \$ 11,537                | \$ 17,205 |
| Net income per common share, basic   | \$ 0.45                  | \$ 0.68   |
| Net income per common share, diluted | \$ 0.44                  | \$ 0.66   |

The unaudited pro forma condensed consolidated results of operations are not necessarily indicative of results that would have occurred had the Sarian acquisition occurred as of the beginning of each of the periods presented above, nor are they necessarily indicative of the results that will be obtained in the future.





**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****2. ACQUISITIONS (CONTINUED)****Spectrum Design Solutions, Inc.**

On July 23, 2008, we acquired Spectrum Design Solutions, Inc. ( Spectrum ), which is a wholly owned subsidiary of Digi International Inc. Prior to the acquisition, Spectrum was a privately held Minneapolis-based corporation and a leading wireless design services organization. The acquisition was a cash merger for \$10.0 million of which \$4.0 million was paid on the acquisition date, \$3.0 million will be paid in January 2010, and the remaining \$3.0 million will be paid in July 2011. These remaining payments totaling \$6.0 million were recorded as a liability on our consolidated balance sheet at their present value of \$5.5 million, on which interest will be accrued up until the time of payment.

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation resulted in non-deductible goodwill of \$5.5 million. We believe that the acquisition resulted in the recognition of goodwill primarily because Spectrum can provide a more complete Drop-in Networking solution to customers who will often need customized gateways, connectware and application development support.

Spectrum's operating results are included in our consolidated results of operations from the date of acquisition. The consolidated balance sheet as of September 30, 2008 reflects the allocation of the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition.

The table below sets forth the final purchase price allocation (in thousands):

|  |              |
|--|--------------|
| Cash, including direct acquisition costs                                   | \$ 4,067     |
| Deferred payments - Spectrum shareholders (present value of \$6.0 million) | 5,537        |
| <br>Total purchase price   | <br>\$ 9,604 |
| <br>Fair value of net tangible assets acquired                             | <br>\$ 283   |
| Identifiable intangible assets:  |              |
| Existing purchased and core technology                                     | 800          |
| Existing customer relationships  | 2,100        |
| Trade names  | 80           |
| Non-compete agreements   | 800          |
| Goodwill   | 5,541        |
|  | \$ 9,604     |

The weighted average useful life for all the identifiable intangibles listed above is 8.5 years. The weighted average useful life for each intangible asset class is as follows: purchased and core technology - 5 years, customer relationships - 11 to 13 years, trade names - 5 years and non-compete agreements - 2 to 4 years.

Useful lives for identifiable intangible assets are estimated at the time of acquisition based on the periods of time from which we expect to derive benefits from the identifiable intangible assets. The identifiable intangible assets are amortized using the straight-line method which reflects the pattern at which the asset is consumed. We do not expect the above intangible assets to have any significant residual value once they become fully amortized.

We have determined that the Spectrum acquisition was not material to our consolidated results of operations or financial condition. Therefore, pro forma financial information is not presented.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****2. ACQUISITIONS (CONTINUED)****MaxStream, Inc.**

On July 27, 2006, we acquired MaxStream, Inc. (MaxStream), a privately held corporation and a leader in the wireless device networking market. The total purchase price of \$40.5 million included \$19.8 million in cash, net of cash acquired of \$3.7 million, and \$20.7 million in common stock, in exchange for all outstanding shares of MaxStream's preferred and common stock and outstanding stock options. This purchase consideration includes an adjustment of \$0.6 million pertaining to the closing working capital of MaxStream as of July 27, 2006. We did not replace MaxStream's outstanding options with Digi options. The value of our common stock was based on a per share value of \$12.35, calculated as the average market price of the common stock during the two business days immediately preceding July 27, 2006 when the parties reached agreement on terms and announced the acquisition.

Cash in the amount of \$1.925 million and 165,090 shares of common stock were deposited to an escrow fund established at Wells Fargo Bank, National Association. These amounts were held in escrow for a period not to exceed one year from the date of closing to satisfy possible claims that could arise pursuant to specific representation and warranty sections of the merger agreement. The escrowed amounts of cash and stock were included in the determination of the purchase consideration on the date of acquisition because our management believed the outcome of the representation and warranty matters was reasonably determinable. We paid the former shareholders the full amount of the escrowed cash and stock from escrow on August 1, 2007.

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation was adjusted by \$0.4 million in March 2007 resulting in an increase in working capital and a reduction in goodwill due to the filing of an amended final tax return for MaxStream. The adjusted purchase price allocation resulted in goodwill of \$26.0 million and a charge of \$2.0 million for acquired in-process research and development. We believe that the acquisition resulted in the recognition of goodwill primarily because MaxStream's wireless technologies and products significantly expand our wireless offering, covering both short and medium range distances using embedded modules and boxed/package solutions, enabling us to provide our customers end-to-end wireless solutions.

MaxStream's operating results are included in our consolidated results of operations from the date of acquisition. The consolidated balance sheets as of September 30, 2008 and 2007 reflect the allocation of the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition.

The table below sets forth the final purchase price allocation (in thousands):

|  |           |
|--|-----------|
| Cash, including cash in escrow and direct acquisition costs  | \$ 19,826 |
| Common stock, including stock in escrow                      | 20,704    |
|  | \$ 40,530 |
| Fair value of net tangible assets acquired                   | \$ 5,090  |
| Identifiable intangible assets:                              |           |
| Existing purchased and core technology                       | 6,900     |
| Existing customer relationships                              | 3,600     |
| Trade names and trademarks                                   | 300       |
| Patent pending / unpatented technology                       | 1,300     |
| In-process research and development                          | 2,000     |
| Goodwill   | 26,059    |
| Deferred tax liabilities related to identifiable intangibles | (4,719)   |
|  | \$ 40,530 |



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****2. ACQUISITIONS (CONTINUED)**

The purchased and core technologies identified above have useful lives ranging between four to nine years, customer relationships have useful lives of ten years, and patents and trademarks have useful lives between five to ten years. Useful lives for identifiable intangible assets are estimated at the time of acquisition based on the periods of time from which we expect to derive benefits from the identifiable intangible assets. The identifiable intangible assets are amortized using the straight-line method which reflects the pattern in which the asset is consumed.

At the time of acquisition, MaxStream had development projects in process associated with the XStream Gen. 2, X. Eleven, Mesh Firmware, Xbee Zigbee Firmware and Xplore products. We estimated that \$2.0 million of the purchase price represented the fair value of acquired in-process research and development related to the products listed below (in thousands) that were under development, had a measurable percentage completed and a documented expected life, had not yet reached technological feasibility, and had no alternative future uses. This amount was expensed as a non-tax-deductible charge upon consummation of the acquisition.

|   |              |
|---|--------------|
| XStream Gen. 2                                | \$ 900       |
| X. Eleven                                     | 500          |
| Mesh Firmware                                 | 400          |
| Xbee Zigbee Firmware                          | 100          |
| Xplore  | 100          |
| <br>Total in-process research and development | <br>\$ 2,000 |

We utilized the income valuation approach to determine the estimated fair value of the acquired in-process research and development. These estimates were based on the following assumptions:

The estimated revenues were based upon our estimate of revenue growth for each of the products over the next five fiscal years, using the assumption that all revenue recorded after that date will be generated from future technologies.

The estimated gross margin was based upon historical gross margin for MaxStream's products, with an increase over time attributable to production synergies.

The estimated operating expenses were based on consideration of historical selling, general and administrative expenses as a percentage of sales and MaxStream's projected operating expenses.

Maintenance research and development, defined as the research and development necessary to sustain the existing technology and its revenue stream, was also included as an operating expense. The estimated remaining cost to complete each in-process research and development technology was also included in operating expenses.

When applying the income valuation approach, the cash flows expected to be generated by an asset are discounted to their present value equivalent using a rate of return that reflects the relative risk of the investment, as well as the time value of money. This return, known as the weighted average cost of capital ( WACC ), is an overall rate based upon the individual rates of return for invested capital (equity and interest-bearing debt). The discount rate used in the income valuation approach was 25%. Premiums were added to the WACC to account for the inherent risks in the development of the products, the risks of the products being completed on schedule, and the risk of the eventual sales of the product meeting our expectations. We used a 40% rate of return for the in-process research and development projects.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****2. ACQUISITIONS (CONTINUED)**

The Xplore and Mesh Firmware projects were released during fiscal year 2007. The XStream Gen. 2 along with the Xbee Zigbee Firmware projects were released in fiscal year 2008. The X. Eleven project is scheduled to be completed during fiscal 2009. These estimates are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur. We anticipate that the projected revenue from these projects will be in line with original projections.

The following unaudited pro forma condensed consolidated results of operations have been prepared as if the acquisition of MaxStream had occurred as of the beginning of the period presented. Pro forma adjustments include amortization of identifiable intangible assets. The pro forma net income for the year ended September 30, 2006 includes the \$2.0 million charge related to acquired in-process research and development associated with the MaxStream acquisition.

(in thousands, except per common share amounts)

|                                      | Year ended<br>September 30,<br>2006 |
|--------------------------------------|-------------------------------------|
| Net sales                            | \$ 155,749                          |
| Net income                           | \$ 10,738                           |
| Net income per common share, basic   | \$ 0.46                             |
| Net income per common share, diluted | \$ 0.45                             |

The unaudited pro forma condensed consolidated results of operations are not necessarily indicative of results that would have occurred had the MaxStream acquisition occurred as of the beginning of the period presented above, nor are they necessarily indicative of the results that will be obtained in the future.

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

Effective April 1, 2005, we acquired FS Forth-Systeme GmbH/Sistemas Embebidos S.A. (collectively referred to as FS Forth) from Embedded Solutions AG of Germany. The purchase price of \$6.5 million in cash included contingent consideration of \$0.8 million paid in October 2006 and the final payment of \$0.9 million, which was paid in October 2007, based on the achievement of milestones identified in the merger agreement.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****3. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS****Identifiable Intangible Assets**

Amortized identifiable intangible assets as of September 30, 2008 and 2007 are comprised of the following (in thousands):

|                                | As of September 30, 2008 |                          |          | As of September 30, 2007 |                          |          |
|--------------------------------|--------------------------|--------------------------|----------|--------------------------|--------------------------|----------|
|                                | Gross carrying amount    | Accumulated amortization | Net      | Gross carrying amount    | Accumulated amortization | Net      |
| Purchased and core technology  | \$46,660                 | \$(30,745)               | \$15,915 | \$38,702                 | \$(26,689)               | \$12,013 |
| License agreements             | 2,440                    | (2,440)                  |          | 2,440                    | (2,290)                  | 150      |
| Patents and trademarks         | 8,906                    | (4,682)                  | 4,224    | 7,925                    | (3,818)                  | 4,107    |
| Customer maintenance contracts | 700                      | (464)                    | 236      | 700                      | (394)                    | 306      |
| Customer relationships         | 18,137                   | (5,472)                  | 12,665   | 11,613                   | (3,975)                  | 7,638    |
| Non-compete agreements         | 1,075                    | (83)                     | 992      |                          |                          |          |
| Total                          | \$77,918                 | \$(43,886)               | \$34,032 | \$61,380                 | \$(37,166)               | \$24,214 |

Amortization expense for fiscal years 2008, 2007 and 2006 is as follows (in thousands):

| Fiscal year | Total   |
|-------------|---------|
| 2008        | \$6,830 |
| 2007        | \$7,579 |
| 2006        | \$7,484 |

Estimated amortization expense for the next five years is as follows (in thousands):

| Fiscal year | Total   |
|-------------|---------|
| 2009        | \$7,700 |
| 2010        | \$7,253 |
| 2011        | \$5,362 |
| 2012        | \$3,952 |
| 2013        | \$2,962 |

**Goodwill**

The changes in the carrying amount of goodwill for fiscal 2008 and 2007 are as follows (in thousands):

|                                  | 2008      | 2007      |
|----------------------------------|-----------|-----------|
| Beginning balance, October 1     | \$ 66,817 | \$ 65,841 |
| Acquisition of Sarian            | 15,432    |           |
| Acquisition of Spectrum          | 5,541     |           |
| Acquisition of MaxStream         |           | (374)     |
| Acquisition of FS Forth          |           | 950       |
| Currency translation adjustments | (1,212)   | 400       |
| Ending balance, September 30     | \$ 86,578 | \$ 66,817 |



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****4. SEGMENT INFORMATION AND MAJOR CUSTOMERS**

We have a single operating and reporting segment. Our revenues consist of products that are in non-embedded and embedded product groupings. Non-embedded products are connected externally to a device or larger system to provide wired or wireless network connectivity or port expansion, while embedded products are being used by a product developer to build an electronic device in which the product provides processing power, wired Ethernet, or wireless network connectivity to that device. The products included in the non-embedded product grouping include cellular routers, gateways, wireless communication adapters, console and serial servers, USB connected products, remote display products, cameras and sensors, serial cards and network management software. The products included in the embedded product grouping include modules, chips, software and development tools, design services, single-board computers and network interface cards. The following table provides revenue by product grouping (in thousands):

|                 | Year ended September 30 |            |            |
|-----------------|-------------------------|------------|------------|
|                 | 2008                    | 2007       | 2006       |
| Non-embedded    | \$ 98,442               | \$ 98,879  | \$ 86,638  |
| Embedded        | 86,614                  | 74,384     | 58,025     |
| Total net sales | \$ 185,056              | \$ 173,263 | \$ 144,663 |

The information in the following table provides revenue by the geographic location of the customer for the years ended September 30, 2008, 2007 and 2006 (in thousands):

|                              | Year ended September 30, |            |            |
|------------------------------|--------------------------|------------|------------|
|                              | 2008                     | 2007       | 2006       |
| North America                | \$ 107,336               | \$ 112,021 | \$ 88,770  |
| Europe, Middle East & Africa | 52,956                   | 41,384     | 35,104     |
| Asia Pacific                 | 19,672                   | 15,597     | 16,557     |
| Latin America                | 5,092                    | 4,261      | 4,232      |
| Total net sales              | \$ 185,056               | \$ 173,263 | \$ 144,663 |

Net property, equipment and improvements by geographic location (in thousands):

|  | As of September 30, |           |           |
|--|---------------------|-----------|-----------|
|  | 2008                | 2007      | 2006      |
| United States                                  | \$ 14,920           | \$ 13,989 | \$ 13,870 |
| International, primarily Europe                | 1,335               | 5,998     | 5,618     |
| Total net property, equipment and improvements | \$ 16,255           | \$ 19,987 | \$ 19,488 |

Our U.S. export sales comprised 34.8%, 31.3% and 35.4% of net sales for the years ended September 30, 2008, 2007 and 2006, respectively.



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****5. SELECTED BALANCE SHEET DATA**

| As of September 30, (in thousands)             | 2008      | 2007      |
|--|-----------|-----------|
| Accounts receivable, net:                      |           |           |
| Accounts receivable                            | \$ 25,007 | \$ 21,501 |
| Less allowance for doubtful accounts           | 697       | 479       |
|  | \$ 24,310 | \$ 21,022 |
| Inventories:                                   |           |           |
| Raw materials                                  | \$ 20,979 | \$ 20,097 |
| Work in process                                | 981       | 816       |
| Finished goods                                 | 8,280     | 5,217     |
|  | \$ 30,240 | \$ 26,130 |
| Property, equipment and improvements, net:     |           |           |
| Land   | \$ 1,800  | \$ 2,447  |
| Buildings                                      | 10,522    | 21,796    |
| Improvements                                   | 3,227     | 3,078     |
| Equipment                                      | 13,940    | 12,254    |
| Purchased software                             | 10,680    | 9,662     |
| Furniture and fixtures                         | 1,445     | 1,662     |
|  | 41,614    | 50,899    |
| Less accumulated depreciation and amortization | 25,359    | 30,912    |
|  | \$ 16,255 | \$ 19,987 |
| Other accrued expenses:                        |           |           |
| Accrued professional fees                      | \$ 507    | \$ 522    |
| Deferred gain on building sale short-term      | 273       |           |
| Contingent purchase price accrual              |           | 950       |
| Other accrued expenses                         | 1,813     | 1,910     |
|  | \$ 2,593  | \$ 3,382  |

Included in equipment at September 30, 2008 is \$1.0 million of equipment under capital leases with accumulated depreciation of \$0.7 million. Depreciation expense was \$2.5 million, \$2.5 million and \$2.7 million for the years ended September 30, 2008, 2007 and 2006, respectively.

**6. 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 due 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

Edgar Filing: DIGI INTERNATIONAL INC - Form 10-K

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 for the years ended September 30, 2008, 2007 and 2006 (in thousands):

|      |             | Balance at | Warranties | Settlements | Balance at |
|------|-------------|------------|------------|-------------|------------|
|      | Fiscal year | October 1, | issued     | made        | September  |
| 2008 |             | \$ 1,155   | \$ 979     | \$(920)     | \$ 1,214   |
| 2007 |             | \$ 1,104   | \$ 877     | \$(826)     | \$ 1,155   |
| 2006 |             | \$ 1,187   | \$ 454     | \$(537)     | \$ 1,104   |
|      |             | 67         |            |             |            |

---

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****6. FINANCIAL GUARANTEES (CONTINUED)**

We are not responsible for and do not warrant that customer software versions created by OEM customers based upon our software source code will function in a particular way, conform to any specifications, 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.

**7. CAPITAL LEASE OBLIGATIONS AND SHORT-TERM BORROWINGS**

On April 22, 2008, we entered into a short-term loan agreement with Wells Fargo Bank, N.A. in the amount of \$25.0 million. This short-term loan was used to finance the Sarian acquisition (see Note 2). Interest was based on a one-month fixed LIBOR rate at the first day of the loan plus 0.30% until May 23, 2008, at which time the rate was changed to a daily LIBOR rate plus 0.30% and ranged between 2.41% and 3.20% from the date of the loan through May 29, 2008. The total interest paid on the loan was \$42,134. Per the terms of the agreement, payment of the outstanding balance was due November 30, 2008; however, we had the option to prepay without penalty. In May 2008, we repaid the entire \$25.0 million utilizing the proceeds from the sales of our marketable securities upon maturity.

On July 26, 2006, we entered into a short-term loan agreement in the amount of \$5.0 million to finance the July 27, 2006 acquisition of MaxStream, Inc. (see Note 2). Interest was based on the daily LIBOR rate plus 0.35% which ranged between 5.64% and 5.70% from the date of the loan through August 17, 2006 and amounted to \$11,619. Per the terms of the agreement, payment of the outstanding balance was due October 31, 2006; however, we had the option to prepay without penalty. We paid the note in full on August 17, 2006.

The following table summarizes future amounts due under capital leases (in thousands):

|  |        |
|--|--------|
| Fiscal Year  |        |
| 2009   | \$ 324 |
| 2010   | 67     |
| 2011   | 1      |
| Total minimum payments required                    | 392    |
| Less interest on capital lease obligations         | (47)   |
| Net minimum principal payments                     | 345    |
| Less capital lease obligations, current portion    | (267)  |
| Capital leases obligations, net of current portion | \$ 78  |

**8. INCOME TAXES**

The components of income before income taxes are as follows (in thousands):

|               | For the years ended September 30, |           |           |
|---------------|-----------------------------------|-----------|-----------|
|               | 2008                              | 2007      | 2006      |
| United States | \$ 16,648                         | \$ 18,375 | \$ 12,287 |
| International | 2,267                             | 5,349     | 2,980     |
|               | \$ 18,915                         | \$ 23,724 | \$ 15,267 |

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

The components of the income tax provision are as follows (in thousands):

|           | For the years ended September 30, |          |          |
|-----------|-----------------------------------|----------|----------|
|           | 2008                              | 2007     | 2006     |
| Current:  |                                   |          |          |
| Federal   | \$ 6,654                          | \$ 2,333 | \$ 2,248 |
| State     | 622                               | 1,119    | 991      |
| Foreign   | 912                               | 614      | (785)    |
| Deferred: |                                   |          |          |
| U.S.      | (1,983)                           | (688)    | 951      |
| Foreign   | 359                               | 573      | 749      |
|           | \$ 6,564                          | \$ 3,951 | \$ 4,154 |

The net deferred tax liability at September 30 consists of the following (in thousands):

|   | 2008       | 2007       |
|---|------------|------------|
| Current deferred tax asset                | \$ 2,100   | \$ 2,096   |
| Non-current deferred tax asset            | 553        | 705        |
| Non-current deferred tax liability        | (7,582)    | (6,667)    |
| Net deferred tax liability                | \$ (4,929) | \$ (3,866) |
|   | 2008       | 2007       |
| Uncollectible accounts and other reserves | \$ 1,705   | \$ 1,097   |
| Depreciation and amortization             | 966        | 1,107      |
| Inventories                               | 126        | 397        |
| Compensation costs                        | 2,142      | 1,406      |
| Tax credit carryforwards                  | 363        | 1,315      |
| Identifiable intangible assets            | (10,231)   | (9,188)    |
| Net deferred tax liability                | \$ (4,929) | \$ (3,866) |

As of September 30, 2008, we have domestic tax credit carryforwards of \$0.2 million the majority of which will expire in 2013. We also have foreign tax credit carryforwards at September 30, 2008 of \$0.2 million, the majority of which will expire in 2013.

We have concluded that it is more likely than not that our deferred tax assets will be realized based on future projected taxable income and the anticipated future reversal of deferred tax liabilities, and therefore no valuation allowance has been established at September 30, 2008. The amount of the deferred tax assets actually realized, however, could vary if there are differences in the timing or amount of future reversals of existing deferred tax liabilities or changes in the amounts of future taxable income. If our future taxable income projections are not realized, a valuation allowance would be required, and would be reflected as income tax expense at the time that any such change in future taxable income is determined.

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

The reconciliation of the statutory federal income tax rate to our effective income tax rate for the years ended September 30 is as follows:

|  | 2008  | 2007   | 2006   |
|--|-------|--------|--------|
| Statutory income tax rate                    | 35.0% | 35.0%  | 35.0%  |
| Increase (decrease) resulting from:          |       |        |        |
| State taxes, net of federal benefits         | 0.2   | 3.5    | 4.2    |
| Utilization of tax credits                   | (2.0) | (4.1)  | (2.7)  |
| Manufacturing deduction                      | (2.6) | (1.3)  | (3.3)  |
| Foreign taxes                                | (0.1) | 0.9    |        |
| Acquired in-process research and development | 2.8   |        | 4.6    |
| Adjustment of tax contingency reserves       | 1.4   | (18.2) | (10.4) |
| Non-deductible stock-based compensation      | 0.7   | 0.5    | 0.8    |
| Other, net                                   | (0.7) | 0.4    | (1.0)  |
|  | 34.7% | 16.7%  | 27.2%  |

Effective October 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48). As a result of our adoption of FIN 48, we recognized an increase in our existing liabilities for unrecognized tax benefits of \$1.1 million and additional deferred tax assets of \$0.6 million, with an offsetting cumulative effect adjustment resulting in a decrease to the opening balance of retained earnings of \$0.5 million. At the adoption date, we had \$3.5 million of gross unrecognized tax benefits and accrued interest and penalties of \$0.5 million. In conjunction with our adoption of FIN 48, we reclassified \$4.0 million of unrecognized tax benefits as a long-term liability as we do not expect significant payments to occur over the next 12 months.

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

|  |          |
|--|----------|
| Unrecognized tax benefits as of October 1, 2007    | \$ 3,464 |
| Increases related to:                              |          |
| Prior year income tax positions                    | 27       |
| Current year income tax positions                  | 471      |
| Decreases related to:                              |          |
| Prior year income tax positions                    | (32)     |
| Settlements  |          |
| Expiration of the statute of limitations           | (278)    |
| Unrecognized tax benefits as of September 30, 2008 | \$ 3,652 |

The total amount of unrecognized tax benefits that if recognized would affect the effective tax rate is \$3.5 million. We recognize interest and penalties related to income tax matters in income tax expense. During the year ended September 30, 2008, we recognized \$0.2 million in interest and penalties. As of September 30, 2008, we have accrued \$0.7 million in interest and penalties on our consolidated balance sheet.

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

During fiscal 2008, we reversed \$0.3 million in income tax reserves primarily associated with the statutory closing of a prior U.S. federal and state tax year. We recorded an additional \$0.2 million of discrete tax benefits



**Table of Contents**

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

**8. INCOME TAXES (CONTINUED)**

as a result of a filing of a prior year tax return and adjustments to actual for items reported on the tax returns for fiscal 2007.

During fiscal 2007, we reversed \$3.6 million in income tax reserves primarily associated with the closing of a German tax audit and the statutory closing of a prior U.S. federal and state tax year. We had established tax reserves that were no longer required as a result of these events. In addition, we also recorded discrete tax benefits of \$0.7 million related to the filing of U.S. amended tax returns, enactment of the extension of the research and development tax credit, and adjustments to actual for items reported on the tax returns filed for fiscal 2006.

During fiscal 2006, we recorded discrete tax benefits of \$1.6 million, primarily related to the settlement of an audit with the French government of certain of our prior fiscal years income tax returns. We had established tax reserves that were no longer required as a result of the settlement.

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 2005 and 2004 in the case of U.S. federal and non-U.S. income tax authorities, respectively, and for tax years generally before fiscal 2004, in the case of state taxing authorities, consisting primarily of Minnesota and California.

The U.S. income tax credit for increased research and development expired on December 31, 2007. Accordingly, the fiscal year 2008 financial statements reflect the credit earned on activity through December 31, 2007. On October 3, 2008 the President signed the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 that retroactively extended the credit until December 31, 2009. The tax benefit of the extended credit earned on activity from January 1, 2008 to September 30, 2008 will be recorded in the first quarter of fiscal 2009.

At September 30, 2008, we have approximately \$5.2 million of accumulated undistributed earnings of controlled foreign subsidiaries that are considered to be reinvested indefinitely as of such date pursuant to paragraph 12 of Accounting Principles Board (APB) No. 23, Accounting for Income Taxes. Accordingly, no deferred tax has been provided on such earnings. If the applicable earnings were remitted to us, applicable U.S. federal tax would be substantially offset by available foreign tax credits.

**9. STOCK-BASED COMPENSATION**

Stock-based awards are granted under the terms of the 2000 Omnibus Stock Plan as Amended and Restated as of November 27, 2006 (the Omnibus Plan) which was ratified on January 22, 2007 at the Annual Meeting of Stockholders, as well as our Stock Option Plan as Amended and Restated as of November 27, 2006 (the Stock Option Plan) and Non-Officer Stock Option Plan as Amended and Restated as of November 27, 2006 (the Non-Officer Plan), both of which expired during the first quarter of fiscal 2007. Additional awards cannot be made under the Stock Option Plan or the Non-Officer Plan. The authority to grant options under the Omnibus Plan and set other terms and conditions rests with the Compensation Committee of the Board of Directors.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****9. STOCK-BASED COMPENSATION (CONTINUED)**

The Stock Option Plan and the Non-Officer Plan include nonstatutory stock options (NSOs) and the Stock Option Plan also includes incentive stock options (ISOs) to employees and others who provide services to us, including consultants, advisers and directors. Options granted under these plans generally vest over a four year service period and will expire if unexercised after ten years from the date of grant. Share awards vest upon continued employment. The exercise price for ISOs and non-employee director options granted under the Stock Option Plan was set at the fair market value of our common stock based on the closing price on the date of grant. The exercise price for NSOs granted under the Stock Option Plan or the Non-Officer Plan was set by the Compensation Committee of the Board of Directors and was set to the exercise price based on the closing price on the date of grant.

The Omnibus Plan authorizes the issuance of up to 3,250,000 common shares in connection with awards of stock options, stock appreciation rights, restricted stock, performance units or stock awards. Eligible participants include our employees, non-employee directors, consultants and advisors. Awards may be granted under the Omnibus Plan until November 27, 2016. Options under the Omnibus Plan can be granted as either ISOs or NSOs. The exercise price shall be determined by our Compensation Committee but shall not be less than the fair market value of our common stock based on the closing price on the date of grant.

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

We recorded cash received from the exercise of stock options of \$1.7 million, \$3.4 million and \$4.6 million during fiscal years 2008, 2007 and 2006, respectively. The excess tax benefits from stock-based compensation were \$0.2 million, \$0.6 million and \$0.7 million during fiscal 2008, 2007 and 2006, respectively. Upon exercise, we issue new shares of stock. The Plans have provisions allowing employees to elect to pay their withholding obligation through share reduction. No employees elected to pay income tax withholding obligations through share reduction during fiscal 2008, 2007 or 2006.

Also, we sponsor an Employee Stock Purchase Plan as Amended and Restated as of November 27, 2006 (the Purchase Plan), covering all domestic employees with at least 90 days of continuous service and who are customarily employed at least 20 hours per week. The Purchase Plan allows eligible participants the right to purchase common stock on a quarterly basis at the lower of 85% of the market price at the beginning or end of each three-month offering period. The Purchase Plan was ratified on January 22, 2007 at the Annual Meeting of Stockholders and provides for the issuance of up to 1,750,000 shares of our Common Stock that may be purchased under the plan. Employee contributions to the Purchase Plan were \$1.0 million in each of the fiscal years ended 2008 and 2007, respectively and \$0.8 million in the fiscal year ended 2006. Pursuant to the Purchase Plan, 117,162, 105,077 and 83,066 common shares were issued to employees during the fiscal years ended 2008, 2007 and 2006, respectively. Shares are issued under the Purchase Plan from treasury stock. As of September 30, 2008, 446,845 common shares were available for future issuances under the Purchase Plan.

Effective October 1, 2005 we adopted Statement of Financial Accounting Standard No. 123 as amended, (SFAS No. 123R), using the modified prospective method of application. Under this method, compensation expense is recognized both for (i) awards granted, modified or settled subsequent to September 30, 2005 and (ii) the nonvested portion of awards granted prior to October 1, 2005. Compensation expense recorded during fiscal 2008 includes approximately \$2.4 million related to awards issued subsequent to September 30, 2005. In addition, compensation expense recorded during fiscal 2008 includes approximately \$1.0 million related to the current vesting portion of awards issued prior to September 30, 2005.



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****9. STOCK-BASED COMPENSATION (CONTINUED)**

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

|  | Year ended September 30, |          |          |
|--|--------------------------|----------|----------|
|  | 2008                     | 2007     | 2006     |
| Cost of sales                                | \$ 181                   | \$ 137   | \$ 89    |
| Sales and marketing                          | 1,251                    | 993      | 694      |
| Research and development                     | 858                      | 703      | 530      |
| General and administrative                   | 1,407                    | 1,192    | 976      |
| Stock-based compensation before income taxes | 3,697                    | 3,025    | 2,289    |
| Income tax benefit                           | (1,223)                  | (1,000)  | (758)    |
| Stock-based compensation after income taxes  | \$ 2,474                 | \$ 2,025 | \$ 1,531 |

Stock-based compensation cost capitalized as part of inventory was immaterial as of September 30, 2008 and 2007. A summary of options and common shares reserved for grant under the Plans and Assumed Plans are as follows (in thousands, except per common share amounts):

|                                      | Options                   |                        | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value (1) |
|--------------------------------------|---------------------------|------------------------|--|--|-------------------------------------|
|                                      | Available<br>for<br>Grant | Options<br>Outstanding |  |  |                                     |
| Balances, September 30, 2005         | 950                       | 4,511                  |  |  |                                     |
| Granted                              | (478)                     | 478                    |  |  |                                     |
| Exercised                            |                           | (615)                  |  |  |                                     |
| Cancelled                            | 125                       | (134)                  |  |  |                                     |
| Balances, September 30, 2006         | 597                       | 4,240                  |  |  |                                     |
| Additional shares approved for grant | 2,500                     |                        |  |  |                                     |
| Granted                              | (653)                     | 653                    |  |  |                                     |
| Exercised                            |                           | (405)                  |  |  |                                     |
| Cancelled                            | 62                        | (62)                   |  |  |                                     |
| Balances, September 30, 2007         | 2,506                     | 4,426                  |  |  |                                     |
| Granted                              | (720)                     | 720                    | \$ 13.88                                 |  |                                     |
| Exercised                            |                           | (182)                  | 9.33                                     |  |                                     |
| Cancelled                            | 156                       | (156)                  | 17.07                                    |  |                                     |
| Balances, September 30, 2008         | 1,942                     | 4,808                  | \$ 11.41                                 | 5.1  | \$ 4,311                            |

Edgar Filing: DIGI INTERNATIONAL INC - Form 10-K

|                                   |       |    |       |     |          |
|-----------------------------------|-------|----|-------|-----|----------|
| Exercisable at September 30, 2006 | 3,300 | \$ | 10.08 |     |          |
| Exercisable at September 30, 2007 | 3,337 | \$ | 10.54 |     |          |
| Exercisable at September 30, 2008 | 3,651 | \$ | 10.74 | 3.9 | \$ 4,239 |

(1) The aggregate intrinsic value represents the total pre-tax intrinsic value, based on our closing stock price of \$10.20 as of September 30, 2008, which would have been received by the option holders had all option holders exercised their options as of that date.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****9. STOCK-BASED COMPENSATION (CONTINUED)**

The intrinsic value of an option is the amount by which the fair value of the underlying stock exceeds its exercise price. The total intrinsic value of all options exercised during each of the twelve months ended September 30, 2008, 2007 and 2006 was \$0.9 million, \$2.4 million and \$2.9 million, respectively. The table below shows the weighted average fair value, which was determined based upon the fair value of each option on the grant date utilizing the Black-Scholes option-pricing model and the related assumptions:

|   | 2008          | 2007          | 2006          |
|---|---------------|---------------|---------------|
| Fair value of options granted (in thousands)      | \$ 3,727      | \$ 3,641      | \$ 2,770      |
| Weighted average per option grant date fair value | \$ 5.17       | \$ 5.58       | \$ 5.79       |
| Assumptions used for option grants:               |               |               |               |
| Risk free interest rate                           | 2.53% - 3.41% | 4.44% - 4.80% | 4.28% - 5.02% |
| Expected term                                     | 4 - 5 years   | 3 - 5 years   | 3 - 5 years   |
| Expected volatility                               | 36% - 45%     | 38% - 52%     | 50% - 60%     |
| Weighted average volatility                       | 40%           | 46%           | 55%           |
| Expected dividend yield                           | 0             | 0             | 0             |

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

A summary of our non-vested options as of September 30, 2008 and changes during the twelve months then ended is presented below (in thousands, except per common share amounts):

|                                 | Number<br>of<br>Options | Weighted<br>Average<br>Grant Date<br>Fair Value per<br>Common Share |
|---------------------------------|-------------------------|---|
| Nonvested at September 30, 2007 | 1,089                   | \$ 5.19   |
| Granted                         | 720                     | 5.17  |
| Vested                          | (594)                   | 5.75  |
| Forfeited                       | (58)                    | 5.20  |
| Nonvested at September 30, 2008 | 1,157                   | \$ 4.89   |

We used historical data to estimate pre-vesting forfeiture rates. The pre-vesting forfeiture rate used in fiscal 2008 was 2.5% during the first three quarters of fiscal 2008 and 2.0% during the fourth quarter of fiscal 2008. As of September 30, 2008 the total unrecognized compensation cost related to non-vested stock-based compensation arrangements net of expected forfeitures was \$5.5 million and the related weighted average period over which it is expected to be recognized is approximately 2.4 years.

The total fair value of shares vested during fiscal 2008 was \$3.4 million, \$2.8 million in fiscal 2007 and \$1.9 in fiscal 2006.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****10. COMMON STOCK REPURCHASE**

On July 23, 2008, our Board of Directors authorized an additional 500,000 shares of our common stock for repurchase under our previously announced stock repurchase program bringing the total number of shares authorized to be repurchased to 1,500,000 shares. During the fourth quarter of fiscal 2008, we began to repurchase our common stock and purchased 471,200 shares for \$5.1 million. As of September 30, 2008, 1,028,800 shares remain available for repurchase.

**11. SALE AND LEASEBACK OF BUILDING**

On February 18, 2008, we entered into a contract for the sale of our building in Dortmund, Germany, and subsequent partial leaseback for a five year term (the Agreement). Upon the closing of the transaction in March 2008, we initiated the leaseback of approximately 40% of the property for a period of five years, with a renewal option for an additional five years.

The building was sold for 4.5 million Euros (equivalent to \$6.9 million), resulting in a gain on sale of 1.0 million Euros (\$1.6 million). As a result of the leaseback, \$1.5 million of the gain on the sale was deferred and is being recognized ratably over the lease term as an offset to rent expense. The remaining \$0.1 million was recognized in the second quarter of fiscal 2008 as a component of general and administrative expense. Of the total sale price, 4.2 million Euros (\$6.5 million) was received during March 2008 and the remaining 0.3 million Euros (\$0.4 million) was received in April 2008. We were required, as part of the Agreement, to deposit 0.3 million Euros (\$0.4 million) into an interest-bearing bank account, which will be refunded to us at the end of the lease term. This deposit was made during March 2008 and is included as restricted cash in other noncurrent assets on our consolidated balance sheet as of September 30, 2008.

**12. MARKETABLE SECURITIES**

Our marketable securities consist of commercial paper, corporate bonds and government municipal bonds. All marketable securities are classified as held-to-maturity and are carried at amortized cost, except for one impaired security, which is carried at expected realizable value.

We review our investments to determine if an impairment exists in any of the securities. During the fourth quarter of fiscal 2008, we recorded an other-than-temporary impairment of \$1,014,900 on a bond issued by Lehman Brothers with a par amount of \$1,194,000. This impairment reflects the estimated decline in the value of this security precipitated by the bankruptcy of the security's issuer. The charge has been recorded as a temporary tax difference as there are sufficient capital gains in the current and available carryback years to utilize the capital loss that will be realized when the bond is disposed of in fiscal 2009. No additional other-than-temporary impairment charges were recorded during fiscal 2008, 2007 and 2006.

We obtained quoted market prices and trading activity for each security, reviewed the financial solvency of each security issuer and obtained other relevant information from our independent investment advisors to estimate the fair value for each security. As of September 30, 2008 and 2007, respectively, 33 and 31 of our securities were trading below our amortized cost basis. Other than the impaired Lehman Brothers security, we determined each decline in value to be temporary based upon the factors described above. Because our securities are classified as held-to-maturity, we expect to realize the full par value of these securities, plus accrued interest, at the time of maturity.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****12. MARKETABLE SECURITIES (CONTINUED)**

Marketable securities were comprised of the following as of September 30, 2008 (in thousands):

|                             | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Market<br>Value |
|-----------------------------|-------------------|---------------------|----------------------|-----------------|
| Corporate bonds (1)         | \$ 55,807         | \$ 12               | \$ (2,771)           | \$ 53,048       |
| Government municipal bonds  | 3,709             |                     | (10)                 | 3,699           |
| Total marketable securities | \$ 59,516         | \$ 12               | \$ (2,781)           | \$ 56,747       |

(1) The Lehman Brothers security is included in amortized cost at an expected realizable value of \$179,100, net of the impairment of \$1,014,900.

Marketable securities were comprised of the following as of September 30, 2007 (in thousands):

|                 | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Market<br>Value |
|-----------------|-------------------|---------------------|----------------------|-----------------|
| Corporate bonds | \$ 69,192         | \$ 33               | \$ (141)             | \$ 69,084       |

Securities that mature within one year are classified as current assets on the balance sheet and securities classified as noncurrent have a maturity of greater than one year from the date of purchase. We do not invest in securities with a maturity in excess of 24 months. The security issued by Lehman Brothers, for which we recorded an other-than-temporary impairment, could take in excess of 24 months to receive our assessed realizable value upon finalization of the bankruptcy proceedings.

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 these 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 additional impairment charges for other securities in our investment portfolio. We will continue to monitor the fair value of securities and relevant market conditions and we will record additional impairment charges in the future if circumstances warrant such charges.

**13. SHARE RIGHTS PLAN**

On April 22, 2008, our Board of Directors extended our share rights plan. Each right entitles its holder to buy one one-hundredth of a share of a Series A Junior Participating Preferred Stock at an exercise price of \$60, subject to adjustment. The rights are not exercisable until a specified distribution date as defined in the Share Rights Agreement. The Rights will expire on June 30, 2018, unless extended or earlier redeemed or exchanged by us as defined in the Share Rights Agreement.

**14. COMMITMENTS**

We have entered into various operating lease agreements for office facilities and equipment, the last of which expires in fiscal 2017. The office facility leases generally require us to pay a pro-rata share of the lessor's operating expenses. Certain operating leases contain escalation clauses and are being amortized on a straight-line basis over the term of the lease. The following schedule reflects future minimum rental commitments

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****14. COMMITMENTS (CONTINUED)**

under noncancelable operating leases. These minimum payments have not been reduced by minimum sublease rentals of an immaterial amount for all future years due under noncancelable subleases.

|                                 | Fiscal Year | Amount<br>(in thousands) |
|---------------------------------|-------------|--------------------------|
| 2009                            |             | \$ 3,064                 |
| 2010                            |             | 2,589                    |
| 2011                            |             | 1,787                    |
| 2012                            |             | 1,424                    |
| 2013                            |             | 815                      |
| Thereafter                      |             | 1,113                    |
| Total minimum payments required |             | \$ 10,792                |

The following schedule shows the composition of total rental expense for all operating leases for the years ended September 30 (in thousands):

|                        | 2008     | 2007     | 2006     |
|------------------------|----------|----------|----------|
| Rentals                | \$ 3,041 | \$ 2,555 | \$ 2,352 |
| Less: sublease rentals | (301)    | (230)    | (127)    |
|                        | \$ 2,740 | \$ 2,325 | \$ 2,225 |

**15. EMPLOYEE BENEFIT PLANS**

We currently have a savings and profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code (the Code), whereby eligible employees may contribute up to 25% of their pre-tax earnings, not to exceed amounts allowed under the Code.

We provide a match of 100% on the first 3% of each employee's bi-weekly contribution and a 50% match on the next 2% of each employee's bi-weekly contribution. In addition, we may make contributions to the plan at the discretion of the Board of Directors. We provided matching contributions of \$1.2 million, \$1.1 million and \$0.9 million in the fiscal years ended September 30, 2008, 2007 and 2006, respectively.

**16. CONTINGENCIES**

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. The complaint names us as a defendant along with NetSilicon, certain of its officers and certain underwriters involved in NetSilicon's IPO, among numerous others, and asserts, among other things, that NetSilicon's IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of NetSilicon's IPO underwriters in allocating shares in NetSilicon's IPO to the underwriters' customers. We believe that the claims against the NetSilicon defendants are without merit and have defended the litigation vigorously. Pursuant to a stipulation between the parties, the two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002. In June 2003, we elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. Had it been approved by the Court, this proposed settlement would have resulted in a dismissal, with prejudice, of all claims in the litigation against us and against any of the other issuer defendants who



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****16. CONTINGENCIES (CONTINUED)**

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

On December 5, 2006, the U.S. Court of Appeals for the Second Circuit issued a decision in In re Initial Public Offering Securities Litigation that six purported class action lawsuits containing allegations substantially similar to those asserted against us could not be certified as class actions due, in part, to the Court of Appeals' determination that individual issues of reliance and knowledge would predominate over issues common to the proposed classes. On January 8, 2007, the plaintiffs filed a petition seeking rehearing en banc of this ruling. On April 6, 2007 the Court of Appeals denied the plaintiffs' petition for rehearing of the Court's December 5, 2006 ruling. The Court of Appeals, however, noted that the plaintiffs remained free to ask the District Court to certify classes different from the ones originally proposed which might meet the standards for class certification that the Court of Appeals articulated in its December 5, 2006 decision. The plaintiffs have since moved for certification of different classes in the District Court, and that motion remains pending.

In light of the Court of Appeals' December 5, 2006 decision regarding certification of the plaintiffs' claims, the District Court entered an order on June 25, 2007 terminating the proposed settlement between the plaintiffs and the issuers, including NetSilicon. Because any possible future settlement with the plaintiffs, if a settlement were ever to be negotiated and ultimately agreed to, would involve the certification of a class action for settlement purposes, the impact of the Court of Appeals' rulings on the possible future settlement of the claims against NetSilicon is uncertain. On August 14, 2007, the plaintiffs filed amended complaints in the six focus cases. The issuer defendants and the underwriter defendants separately moved to dismiss the claims against them in the amended complaints in the six focus cases. On March 26, 2008, the District Court issued an order in which it denied in substantial part the motions to dismiss the amended complaints in the six focus cases. In addition, on October 1, 2007, the plaintiffs submitted their briefing in support of their motions to certify different classes in the six focus cases. The issuer defendants and the underwriter defendants filed separate oppositions to those motions on December 21, 2007. The plaintiffs have voluntarily withdrawn their motions for class certification without prejudice.

We intend to continue to defend the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit. We maintain liability insurance for such matters and expect that the liability insurance will be adequate to cover any potential unfavorable outcome, less the applicable deductible amount of \$250,000 per claim. As of September 30, 2008, we have accrued a liability for the deductible amount of \$250,000 which we believe reflects the amount of loss that is probable. In the event we have losses that exceed the limits of the liability insurance, such losses could have a material effect on our business and our consolidated results of operations or financial condition.

In addition to the matter 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 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****17. QUARTERLY FINANCIAL DATA (UNAUDITED)**

| (in thousands, except per common share data) | Quarter ended |          |          |          |
|--|---------------|----------|----------|----------|
|  | Dec. 31       | Mar. 31  | June 30  | Sept. 30 |
| 2008   |               |          |          |          |
| Net sales                                    | \$44,574      | \$43,070 | \$46,995 | \$50,417 |
| Gross profit                                 | 23,895        | 23,177   | 24,857   | 25,940   |
| Net income (1)(2)                            | 3,670         | 3,097    | 1,985    | 3,599    |
| Net income per common share basic            | 0.14          | 0.12     | 0.08     | 0.14     |
| Net income per common share diluted          | 0.14          | 0.12     | 0.08     | 0.14     |
| 2007   |               |          |          |          |
| Net sales                                    | \$41,811      | \$42,855 | \$43,527 | \$45,070 |
| Gross profit                                 | 22,013        | 22,511   | 23,003   | 23,819   |
| Net income (1)                               | 3,802         | 3,597    | 6,798    | 5,576    |
| Net income per common share basic            | 0.15          | 0.14     | 0.27     | 0.22     |
| Net income per common share diluted          | 0.15          | 0.14     | 0.26     | 0.21     |

(1) During 2008 and 2007, we recorded discrete income tax benefits of \$0.5 million and \$4.3 million, respectively. Discrete income tax benefits for fiscal 2008 were recorded of \$0.2 million in the third quarter and \$0.3 million in the fourth quarter related to the reversal of income tax reserves associated with the closing of a prior U.S. federal and state tax year. Discrete income tax benefits for fiscal 2007 were recorded of \$0.5 million in

the first quarter, \$2.9 million in the third quarter and \$0.9 million in the fourth quarter related to the reversal of income tax reserves of \$3.6 million associated with the closing of a German tax audit and the statutory closing of a prior U.S. federal and state tax year and \$0.7 million primarily due to adjustments to actual for items reported on the tax return filed for fiscal 2006.

- (2) During the third quarter of fiscal 2008, we incurred a \$1.9 million charge with no related income tax benefit for in-process research and development associated with the acquisition of Sarian.

**Table of Contents**

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

None.

**ITEM 9A. 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 are effective.

**Management's Report on Internal Control over Financial Reporting**

We are responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

We assessed the effectiveness of our internal control over financial reporting as of September 30, 2008 using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on this assessment, we concluded that our internal control over financial reporting was effective as of September 30, 2008. Our assessment of the effectiveness of our internal control over financial reporting as of September 30, 2008 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears in Item 8 of this report.

On April 28, 2008, we acquired Sarian Systems, Ltd. (Sarian). Sarian, whose assets represented 2.4% of total consolidated assets as of September 30, 2008 and whose total net sales represented 3.1% of total consolidated net sales for the year ended September 30, 2008, was acquired in a purchase business combination and was excluded from our September 30, 2008 assessment of the effectiveness of our internal control over financial reporting.

**Changes in Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None

**Table of Contents****PART III****ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE****Executive Officers of the Registrant**

As of the date of filing this Form 10-K, the following individuals were executive officers of the Registrant:

| Name                 | Age | Position  |
|----------------------|-----|---|
| Joseph T. Dunsmore   | 50  | Chairman, President and Chief Executive Officer                               |
| Subramanian Krishnan | 54  | Senior Vice President, Chief Financial Officer and Treasurer                  |
| Lawrence A. Kraft    | 42  | Senior Vice President of Sales and Marketing                                  |
| Joel K. Young        | 44  | Senior Vice President of Research and Development and Chief Technical Officer |

Mr. Dunsmore joined our company in October 1999 as President and Chief Executive Officer and a member of the Board of Directors and was elected Chairman of the Board in May 2000. Prior to joining us, Mr. Dunsmore was Vice President of Access for Lucent Microelectronics, a telecommunications company now known as Agere Systems Inc., since June 1999. From October 1998 to June 1999, he acted as an independent consultant to various high technology companies. From February 1998 to October 1998, Mr. Dunsmore was Chief Executive Officer of NetFax, Inc., a telecommunications company. From October 1995 to February 1998, he held executive management positions at US Robotics and then at 3COM after 3COM acquired US Robotics in June 1997. Prior to that, Mr. Dunsmore held various marketing management positions at AT&T Paradyne Corporation from May 1983 to October 1995.

Mr. Krishnan was named Senior Vice President, Chief Financial Officer and Treasurer on February 1, 1999, prior to which he served as our Vice President of Finance since January 11, 1999. Prior to joining us, he served as a principal with LAWCO Financial, an investment banking firm in Minneapolis, Minnesota from January 1997 to January 1999. Prior to LAWCO, he served for 13 years with the Valspar Corporation as the Director of Corporate Financial Planning and Reporting and Taxes and was primarily responsible for mergers, acquisitions and joint ventures.

Mr. Kraft joined our company as Vice President of Americas Sales and Marketing in February 2003 and was named Senior Vice President of Sales and Marketing in November 2005. Prior to joining us, Mr. Kraft was Vice President of Marketing for Advanced Switching Communications (ASC), a provider of broadband access platforms, from June 1999 to February 2002. From July 1998 to October 1998, Mr. Kraft was Vice President of Marketing for NetFax, Inc., a telecommunications company. Mr. Kraft also previously held the positions of Manager of Product Marketing at 3COM/U.S. Robotics, Vice President of Marketing for ISDN Systems Corporation, and Group Products Manager for the Internet access program at Sprint Corporation.

Mr. Young joined our company in July 2000 as Vice President of Engineering and was named Vice President of Research and Development and Chief Technical Officer in November 2005. In October 2006, Mr. Young was named Senior Vice President of Research and Development and Chief Technical Officer. Prior to joining us, Mr. Young served as a Vice President for Transcript International, a provider of encryption products, in various engineering, sales and marketing positions from February 1996 to June 2000. Before that, he held various engineering and management positions at AT&T and AT&T Bell Laboratories from 1986 to 1996.

**Table of Contents****ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE (CONTINUED)****Code of Ethics**

We adopted a code of ethics within the meaning of Rule 406 of Regulation S-K, which is applicable to our senior financial management, including specifically our principal executive officer, principal chief financial officer and controller. A copy of this code of ethics is listed as an exhibit to this report. We intend to satisfy our disclosure obligations regarding any amendment to, or a waiver from, a provision of this code of ethics by posting such information on our website at [www.digi.com](http://www.digi.com). We also have a code of conduct that applies to all directors, officers and employees, a copy of which is available through our website ([www.digi.com](http://www.digi.com)) under the About us Investor Relations Corporate Governance caption.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS****Equity Compensation Plan Information**

The following table gives information about the Company's Common Stock that may be issued upon the exercise of options under all of the Company's existing equity compensation plans as of September 30, 2008.

| Plan Category  | (a)   | (b)   | (c)   |
|--|---|---|---|
|  | Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights | Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
| Equity Compensation Plans Approved by Security Holders         | 2,826,706   | \$ 11.96  | 2,260,445(1)  |
| Equity Compensation Plans Not Approved by Security Holders (2) | 1,117,588   | \$ 9.33   | -0-   |
| Total (3)  | 3,944,294   | \$ 11.22  | 2,260,445   |

(1) Includes securities available for future issuance under stockholder approved compensation plans other than

upon the exercise of options, warrants or rights, as follows: 1,813,600 shares under the Company's 2000 Omnibus Stock Plan and 446,845 shares under the Company's Employee Stock Purchase Plan.

- (2) Relates to the Digi International Inc. Non-Officer Stock Option Plan only.
- (3) The table does not include information for equity compensation plans assumed by the Company pursuant to the acquisition of NetSilicon, Inc. in February 2002. Pursuant to the Agreement and Plan of Merger, the Company assumed options to purchase 4,134,658 shares of common stock of NetSilicon granted under three different plans, which became

exercisable for an aggregate of 2,687,528 shares of common stock of the Company. All of the options assumed by the Company remain subject to the assumed plans until the options are exercised or expire. As of September 30, 2008, 864,188 options remained outstanding at a weighted average exercise price of \$12.25. The Company cannot grant additional awards under these assumed plans.



**Table of Contents**

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS (CONTINUED)**

**Equity Compensation Plan Not Approved by Stockholders Digi International Inc. Non-Officer Stock Option Plan**

In April 1998, the Board adopted the Digi International Inc. Non-Officer Stock Option Plan (the Non-Officer Plan ). The Non-Officer Plan has not been approved by the stockholders of the Company.

***Plan Administration***

The Non-Officer Plan is administered by a committee of two or more members of the Board (the Committee). The Committee may delegate all or any part of its authority to a one person committee consisting of the Chief Executive Officer of the Company for purposes of granting awards.

***Shares Subject to the Non-Officer Plan***

As of September 30, 2008, 1,117,588 shares of the Company s common stock were subject to outstanding awards granted under this Plan. No shares are available for future award grants, and no additional awards may be made under this Plan. Pursuant to the Non-Officer Plan, the Committee must adjust the number of shares and the purchase price per share to give effect to adjustments made in the number of outstanding common stock of the Company pursuant to mergers, consolidations, splits, combinations, or other changes in capitalization as described in the Non-Officer Plan.

***Eligibility***

All employees of the Company and its subsidiaries who are not also officers or directors of the Company, and consultants to the Company or its subsidiaries, were eligible to receive awards under the Non-Officer Plan.

***Incentive and Non-Statutory Stock Options***

The Non-Officer Plan authorizes the grant of non-statutory stock options. Because the Non-Officer Plan has not been approved by the Company s stockholders, under the Internal Revenue Code of 1986, as amended, incentive stock options were not granted under the Non-Officer Plan. The exercise price of an option was determined by the Committee. The exercise price could not be less than 50% of the fair market value, as defined in the Non-Officer Plan, of the Company s common stock on the date the option is granted. Stock options could be granted and exercised at such times as the Committee may determine, provided that the term could not exceed ten years from the date of grant. The purchase price for common stock purchased upon the exercise of stock options may be payable in cash, bank draft or money order, by delivery of shares of Company common stock having a fair market value on the date the option is exercised equal to all or any part of the option price of the common stock being purchased or any combination of the above.

***Transferability and Termination of Options***

The Non-Officer Plan allows the recipient to transfer options to members of his or her immediate family under certain circumstances. Other than such transfers to family members, no option shall be assignable or transferable by the recipient other than by will or the laws of descent and distribution. If a recipient s employment or other relationship with the Company or its affiliates is terminated for any reason other than death or disability, then any unexercised portion of such recipient s award will generally be forfeited, except as provided in the Non-Officer Plan or such recipient s agreement or by the Committee. Upon death or disability, any unexercised portion of such recipient s award will automatically vest. Upon a change in control as described in the Non-Officer Plan, the Committee shall declare all outstanding options cancelled at the time of the change in control in exchange for cash in the amount described in the Non-Officer Plan unless appropriate provisions have been made for the protection of the outstanding options by the substitution of such options for options to purchase appropriate stock of the surviving entity in the change in control.

**Table of Contents**

**ITEM 12. SECURITY  
OWNERSHIP OF  
CERTAIN  
BENEFICIAL  
OWNERS AND  
MANAGEMENT  
AND RELATED  
STOCKHOLDER  
MATTERS  
(CONTINUED)**

***Adjustments, Modifications, Termination***

The Non-Officer Plan gives the Board the right to amend, suspend or discontinue the Non-Officer Plan. Amendments to the Non-Officer Plan are subject to stockholder approval, however, if needed to comply with applicable laws or regulations. The Committee may generally also alter or amend any agreement covering an award granted under the Non-Officer Plan to the extent permitted by law.

**Table of Contents**

**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES**

(a) Consolidated Financial Statements and Schedules of the Company

1. Consolidated Statements of Operations for the fiscal years ended September 30, 2008, 2007 and 2006

Consolidated Balance Sheets as of September 30, 2008 and 2007

Consolidated Statements of Cash Flows for the fiscal years ended September 30, 2008, 2007 and 2006

Consolidated Statements of Stockholders' Equity and Comprehensive Income for the fiscal years ended September 30, 2008, 2007 and 2006

Notes to Consolidated Financial Statements

2. Schedule of Valuation and Qualifying Accounts

3. Report of Independent Registered Public Accounting Firm

(b) Exhibits

Exhibit

Number Description

- |      |  |
|------|--|
| 2(a) | Agreement and Plan of Merger among the Company, Dove Sub Inc. and NetSilicon, Inc. dated as of October 30, 2001 (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request) (1)  |
| 2(b) | Purchase and assignment contract dated March 20, 2005 between Embedded Solutions AG, Klaus Flesch, Angelika Flesch and Digi International GmbH (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request) (2)                                 |
| 2(c) | Agreement and Plan of Merger among Digi International Inc., Karat Sub Inc. and Z-World, Inc. dated as of May 26, 2005 (excluding schedules and exhibits, which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request) (3)   |
| 2(d) | Agreement and Plan of Merger among Digi International Inc., Ocean Acquisition Sub Inc. and MaxStream, Inc. dated as of July 27, 2006 (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request) (4)   |
| 2(e) | Share Purchase Agreement dated April 28, 2008 among Digi International Limited, a subsidiary of Digi International Inc., and all of the shareholders of Sarian Systems Limited (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request) (5) |

**Table of Contents**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES (CONTINUED)**

| Exhibit<br>Number | Description   |
|-------------------|---|
| 3(a)              | Restated Certificate of Incorporation of the Company, as amended (6)  |
| 3(b)              | Amended and Restated By-Laws of the Company, as amended (7)   |
| 4(a)              | Share Rights Agreement, dated as of April 22, 2008, between the Company and Wells Fargo Bank, N.A., as Rights Agent (8)   |
| 4(b)              | Form of Amended and Restated Certificate of Powers, Designations, Preferences and Rights of Series A Junior Participating Preferred Shares (9)                                  |
| 10(a)             | Digi International Inc. Stock Option Plan as Amended and Restated as of November 27, 2006* (10)   |
| 10(b)             | Form of indemnification agreement with directors and officers of the Company (11)   |
| 10(c)             | Agreement between the Company and Subramanian Krishnan dated March 26, 1999 (12)  |
| 10(c)(i)          | Amendment to Agreement between the Company and Subramanian Krishnan dated February 5, 2001* (13)  |
| 10(d)             | Employment Agreement between the Company and Joseph T. Dunsmore dated September 27, 2006* (14)  |
| 10(e)             | Digi International Inc. Employee Stock Purchase Plan, as Amended and Restated, of the Company as of November 27, 2006, as approved by stockholders on January 22, 2007*(15)     |
| 10(f)             | Digi International Inc. 2000 Omnibus Stock Plan as Amended and Restated as of November 27, 2006, as approved by stockholders on January 22, 2007* (16)                          |
| 10(g)             | Digi International Inc. Non-Officer Stock Option Plan, as Amended and Restated as of November 27, 2006 (17)   |
| 10(h)             | NetSilicon, Inc. Amended and Restated 1998 Director Stock Option Plan (18)  |
| 10(i)             | NetSilicon, Inc. Amended and Restated 1998 Incentive and Non-Qualified Stock Option Plan (19)   |
| 10(j)             | NetSilicon, Inc. 2001 Stock Option and Incentive Plan (20)  |
| 10(k)             | Form of Notice of Grant of Stock Options and Option Agreement and Terms and Conditions of Nonstatutory Stock Option Agreement (Digi International Inc. Stock Option Plan)* (21) |
| 10(l)             | Fiscal 2007 Executive Officer Compensation* (22)  |
| 10(m)             | Agreement between the Company and Lawrence A. Kraft, dated February 4, 2003* (23)   |
| 10(m)(i)          | Amendment to Agreement between the Company and Lawrence A. Kraft dated July 30, 2007* (24)  |

**Table of Contents**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES (CONTINUED)**

| Exhibit<br>Number | Description  |
|-------------------|--|
| 10(n)             | Agreement between the Company and Joel K. Young dated July 30, 2007* (25)  |
| 10(o)             | Form of Notice of Grant of Stock Options and Option Agreement and Terms and Conditions of Nonstatutory Stock Option Agreement (Digi International Inc. 2000 Omnibus Stock Plan)* |
| 10(p)             | English Language Summary of Sale and Leaseback Agreement dated February 18, 2008 between Digi International GmbH and Deutsche Structured Finance GmbH & Co. Alphard KG. (26)     |
| 14                | Code of Ethics (27)  |
| 21                | Subsidiaries of the Company  |
| 23                | Consent of Independent Registered Public Accounting Firm   |
| 24                | Powers of Attorney   |
| 31(a)             | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer  |
| 31(b)             | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer  |
| 32                | Section 1350 Certification   |

\* Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K.

- (1) Incorporated by reference to Annex A to the Company's Registration Statement on Form S-4 (File no. 333-74118).
- (2) Incorporated by reference to Exhibit 2(a) to the Company's Form 10-Q for the quarter ended March 31, 2005 (File no. 0-17972).
- (3) Incorporated by reference to Exhibit 2 to the Company's Form 8-K dated May 26, 2005 (File no. 0-17972).
- (4) Incorporated by reference to Exhibit 2 to the Company's Form 8-K dated July 27, 2006 (File no. 0-17972)
- (5) Incorporated by reference to Exhibit 2(a) to the Company's Form 10-Q for the quarter ended March 31, 2008 (File No. 1-34033)
- (6) 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).

- (7) 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).
- (8) 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).
- (9) 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).

**Table of Contents**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES (CONTINUED)**

- (10) Incorporated by reference to Exhibit 10(a) to the Company's Form 10-K for the year ended September 30, 2006 (File no. 0-17972).
- (11) Incorporated by reference to Exhibit 10(b) to the Company's Registration Statement on Form S-1 (File no. 33-30725).
- (12) Incorporated by reference to Exhibit 10(k) to the Company's Form 10-Q for the quarter ended March 31, 1999 (File no. 0-17972).
- (13) Incorporated by reference to Exhibit 10(e)(i) to the Company's Form 10-Q for the quarter ended December 31, 2000 (File no. 0-17972).
- (14) Incorporated by reference to Exhibit 10(d) to the Company's Form 10-K for the year ended September 30, 2006 (File no. 0-17972).
- (15) Incorporated by reference to Exhibit 10(b) to the Company's Form 10-Q for the quarter ended December 31, 2006 (File no. 0-17972).
- (16) Incorporated by reference to Exhibit 10(a) to the Company's Form 10-Q for the quarter ended December 31, 2006 (File no. 0-17972).
- (17) Incorporated by reference to Exhibit 10(g) to the Company's Form 10-K for the year ended September 30, 2006 (File no. 0-17972).
- (18) Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 dated February 13, 2002 (File no. 333-82672).
- (19) Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 dated February 13, 2002 (File no. 333-82670).
- (20) Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 dated February 13, 2002 (File no. 333-82668).
- (21) Incorporated by reference to Exhibit 10(a) to the Company's Form 8-K dated September 13, 2004 (File no. 0-17972).
- (22) Incorporated by reference to Item 1.01 of the Company's Form 8-K dated September 29, 2006 (File no. 0-17972)
- (23) Incorporated by reference to Exhibit 10(m) to the Company's Form 10-K for the year ended September 30, 2006 (File no. 0-17972).
- (24) Incorporated by reference to Exhibit 10(a) to the Company's Form 10-Q for the quarter ended June 30, 2007 (File no. 0-17972)
- (25) Incorporated by reference to Exhibit 10(b) to the Company's Form 10-Q for the quarter ended June 30, 2007 (File no. 0-17972)
- (26)

Edgar Filing: DIGI INTERNATIONAL INC - Form 10-K

Incorporated by reference to Exhibit 10(a) to the Company's Form 10-Q for the quarter ended March 31, 2008 (File no. 1-34033).

(27) Incorporated by reference to Exhibit 14 to the Company's Form 10-K for the year ended September 30, 2003 (File no. 0-17972).



**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

December 5, 2008

By: /s/ Joseph T. Dunsmore  
Joseph T. Dunsmore  
President, Chief Executive Officer, Chairman, and  
Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

December 5, 2008

/s/ Joseph T. Dunsmore  
Joseph T. Dunsmore  
President, Chief Executive Officer, Chairman, and  
Director  
(Principal Executive Officer)

December 5, 2008

/s/ Subramanian Krishnan  
Subramanian Krishnan  
Senior Vice President, Chief Financial Officer and  
Treasurer  
(Principal Financial and Accounting Officer)

**GUY C. JACKSON**  
**KENNETH E. MILLARD**  
**AHMED NAWAZ**  
**WILLIAM N. PRIESMEYER**  
**BRADLEY J. WILLIAMS**

A majority of the Board of Directors\*

\* Joseph T.  
Dunsmore, by  
signing his  
name hereto,  
does hereby  
sign this  
document on  
behalf of each  
of the above  
named directors  
of the Registrant  
pursuant to  
Powers of  
Attorney duly

executed by  
such persons.

December 5, 2008

/s/ Joseph T. Dunsmore  
Joseph T. Dunsmore  
Attorney-in-fact  
89

---

Table of Contents

**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS  
DIGI INTERNATIONAL INC.**

(in thousands)

| Description   | Balance at<br>beginning<br>of period | Charged<br>(Credited)<br>to<br>costs and<br>expenses | Deductions  | Balance at<br>end of<br>period |
|---|--------------------------------------|--|-------------|--------------------------------|
| Valuation account doubtful accounts   |                                      |  |             |                                |
| September 30, 2008  | \$ 479                               | \$ 308   | \$ 90(1)    | \$ 697                         |
| September 30, 2007  | \$ 495                               | \$ 73  | \$ 89(1)    | \$ 479                         |
| September 30, 2006  | \$ 872                               | \$ (204)   | \$ 173(1)   | \$ 495                         |
| Reserve for future returns and pricing adjustments                                  |                                      |  |             |                                |
| September 30, 2008  | \$1,442                              | \$ 9   | \$ 82(2)    | \$1,369                        |
| September 30, 2007  | \$1,807                              | \$ (166)   | \$ 199(2)   | \$1,442                        |
| September 30, 2006  | \$1,692                              | \$ (164)   | \$ (279)(2) | \$1,807                        |
| (1) Uncollectible<br>accounts<br>charged against<br>allowance, net<br>of recoveries |                                      |  |             |                                |
| (2) Adjustments<br>and recoveries   |                                      |  |             |                                |

**Table of Contents****EXHIBIT INDEX**

| Exhibit | Description  | Page                      |
|---------|--|---------------------------|
| 2(a)    | Agreement and Plan of Merger among the Company, Dove Sub Inc. and NetSilicon, Inc. dated as of October 30, 2001 (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request)  | Incorporated by Reference |
| 2(b)    | Purchase and assignment contract dated March 20, 2005 between Embedded Solutions AG, Klaus Flesch, Angelika Flesch and Digi International GmbH (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request)                                 | Incorporated by Reference |
| 2(c)    | Agreement and Plan of Merger among Digi International Inc., Karat Sub Inc. and Z-World, Inc. dated as of May 26, 2005 (excluding schedules and exhibits, which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request)   | Incorporated by Reference |
| 2(d)    | Agreement and Plan of Merger among Digi International Inc., Ocean Acquisition Sub Inc. and MaxStream, Inc. dated as of July 27, 2006 (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request)   | Incorporated by Reference |
| 2(e)    | Share Purchase Agreement dated April 28, 2008 among Digi International Limited, a subsidiary of Digi International Inc., and all of the shareholders of Sarian Systems Limited (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request) | Incorporated by Reference |
| 3(a)    | Restated Certificate of Incorporation of the Company, as amended   | Incorporated by Reference |
| 3(b)    | Amended and Restated By-Laws of the Company, as amended  | Incorporated by Reference |
| 4(a)    | Share Rights Agreement, dated as of April 22, 2008, between the Company and Wells Fargo Bank, N.A., as Rights Agent  | Incorporated by Reference |
| 4(b)    | Form of Amended and Restated Certificate of Powers, Designations, Preferences and Rights of Series A Junior Participating Preferred Shares   | Incorporated by Reference |
| 10(a)   | Digi International Inc. Stock Option Plan as Amended and Restated as of November 27, 2006  | Incorporated by Reference |
| 10(b)   | Form of indemnification agreement with directors and officers of the Company   | Incorporated by Reference |
| 10(c)   |  |                           |

|          |  |                           |
|----------|--|---------------------------|
|          | Agreement between the Company and Subramanian Krishnan dated March 26, 1999  | Incorporated by Reference |
| 10(c)(i) | Amendment to Agreement between the Company and Subramanian Krishnan dated February 5, 2001   | Incorporated by Reference |
| 10(d)    | Employment Agreement between the Company and Joseph T. Dunsmore dated September 27, 2006   | Incorporated by Reference |
| 10(e)    | Digi International Inc. Employee Stock Purchase Plan, as Amended and Restated, of the Company as of November 27, 2006, as approved by stockholders on January 22, 2007 | Incorporated by Reference |
| 10(f)    | Digi International Inc. 2000 Omnibus Stock Plan as Amended and Restated as of November 27, 2006, as approved by stockholders on January 22, 2007                       | Incorporated by Reference |
| 10(g)    | Digi International Inc. Non-Officer Stock Option Plan, as Amended and Restated as of November 27, 2006   | Incorporated by Reference |
| 10(h)    | NetSilicon, Inc. Amended and Restated 1998 Director Stock Option Plan  | Incorporated by Reference |

**Table of Contents****EXHIBIT INDEX (CONTINUED)**

| Exhibit  | Description   | Page                      |
|----------|---|---------------------------|
| 10(i)    | NetSilicon, Inc. Amended and Restated 1998 Incentive and Non-Qualified Stock Option Plan  | Incorporated by Reference |
| 10(j)    | NetSilicon, Inc. 2001 Stock Option and Incentive Plan   | Incorporated by Reference |
| 10(k)    | Form of Notice of Grant of Stock Options and Option Agreement and Terms and Conditions of Nonstatutory Stock Option Agreement (Digi International Inc. Stock Option Plan)       | Incorporated by Reference |
| 10(l)    | Fiscal 2007 Executive Officer Compensation  | Incorporated by Reference |
| 10(m)    | Agreement between the Company and Lawrence A. Kraft, dated February 4, 2003   | Incorporated by Reference |
| 10(m)(i) | Amendment to Agreement between the Company and Lawrence A. Kraft dated July 30, 2007  | Incorporated by Reference |
| 10(n)    | Agreement between the Company and Joel K. Young dated July 30, 2007   | Incorporated by Reference |
| 10(o)    | Form of Notice of Grant of Stock Options and Option Agreement and Terms and Conditions of Nonstatutory Stock Option Agreement (Digi International Inc. 2000 Omnibus Stock Plan) | Filed Electronically      |
| 10(p)    | English Language Summary of Sale and Leaseback Agreement dated February 18, 2008 between Digi International GmbH and Deutsche Structured Finance GmbH & Co. Alphard KG.         | Incorporated by Reference |
| 15       | Code of Ethics  | Incorporated by Reference |
| 22       | Subsidiaries of the Company   | Filed Electronically      |
| 23       | Consent of Independent Registered Public Accounting Firm  | Filed Electronically      |
| 24       | Powers of Attorney  | Filed Electronically      |
| 31(a)    | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer   | Filed Electronically      |
| 31(b)    | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer   | Filed Electronically      |
| 32       | Section 1350 Certification  | Filed Electronically      |