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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: June 30, 2001.

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: 0-17972

DIGI INTERNATIONAL INC.

-----  
(Exact name of registrant as specified in its charter)

Delaware

41-1532464

-----  
(State or other jurisdiction of  
incorporation or organization)

-----  
(I.R.S. Employer  
Identification Number)

11001 Bren Road East  
Minnetonka, Minnesota 55343

-----  
(Address of principal executive offices) (Zip Code)

(952) 912-3444

-----  
(Registrant's telephone number, including area code)

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

Yes [X] No [ ]

On August 10, 2001, there were 15,328,643 shares of the registrant's \$.01 par  
value Common Stock outstanding.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

DIGI INTERNATIONAL INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS  
 FOR THREE MONTHS AND NINE MONTHS ENDED JUNE 30, 2001 AND 2000  
 (UNAUDITED)

	Three months ended June 30		Nine months ended June 30	
	2001	2000	2001	2000
Net sales	\$30,154,901	\$32,354,163	\$97,635,904	\$ 98,294,133
Cost of sales	14,473,872	15,179,195	46,595,914	46,670,982
Gross margin	15,681,029	17,174,968	51,039,990	51,623,151
Operating expenses:				
Sales and marketing	7,897,975	8,551,082	23,168,884	25,865,537
Research and development	4,607,979	4,582,384	14,215,911	15,661,706
General and administrative	3,503,212	3,868,033	11,916,326	14,923,459
Impairment loss				18,068,249
Restructuring	(298)	(11,883)	(230,067)	(150,350)
Total operating expenses	16,008,868	16,989,616	49,071,054	74,368,601
Operating (loss) income	(327,839)	185,352	1,968,936	(22,745,450)
Other income	587,921	760,560	2,068,254	9,911,105
Income (loss) before income taxes	260,082	945,912	4,037,190	(12,834,345)
Income tax provision (benefit)	120,927	(1,567,267)	1,978,253	(3,083,095)
Net income (loss)	\$ 139,155	\$ 2,513,179	\$ 2,058,937	\$ (9,751,250)
Net income (loss) per common share, basic	\$ 0.01	\$ 0.17	\$ 0.14	\$ (0.65)
Net income (loss) per common share, assuming dilution	\$ 0.01	\$ 0.17	\$ 0.14	\$ (0.65)
Weighted average common shares, basic	15,243,716	15,095,436	15,206,085	15,041,935
Weighted average common shares, assuming dilution	15,319,619	15,100,718	15,228,835	15,041,935

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

DIGI INTERNATIONAL INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEET  
AS OF JUNE 30, 2001 AND SEPTEMBER 30, 2000

	June 30 2001 ----- (unaudited)	September 30 2000 -----
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 13,150,077	\$ 38,785,936
Marketable securities	37,189,561	20,150,132
Accounts receivable, net	23,636,504	18,175,226
Inventories, net	20,342,309	19,700,010
Other	3,939,756	3,655,511
	-----	-----
Total current assets	98,258,207	100,466,815
Property, equipment and improvements, net	22,808,599	24,408,384
Intangible assets, net	22,320,870	16,397,744
Other	1,615,412	1,649,252
	-----	-----
Total assets	\$145,003,088 =====	\$142,922,195 =====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Borrowings under line of credit agreements	\$ 1,727,600	\$ 3,147,900
Current portion of long-term debt	194,278	330,305
Accounts payable	6,250,595	6,275,995
Income taxes payable	1,250,906	1,328,481
Accrued expenses:		
Advertising	907,648	1,143,565
Compensation	4,550,349	1,862,517
Other	5,778,547	6,760,841
Restructuring reserves	21,309	1,531,992
	-----	-----
Total current liabilities	20,681,232	22,381,596
Long-term debt	6,566,769	7,081,396
Net deferred income taxes	1,101,294	
	-----	-----
Total liabilities	28,349,295	29,462,992
Commitments and contingency		
Stockholders' equity:		
Preferred stock, \$.01 par value: 2,000,000 shares authorized; none outstanding		
Common stock, \$.01 par value: 60,000,000 shares authorized; 16,418,123 and 16,322,949 issued	164,181	163,229
Additional paid-in capital	71,780,277	71,851,928
Retained earnings	63,468,798	61,409,861
Accumulated other comprehensive income	92,458	166,750
	-----	-----
Total stockholders' equity	135,505,714	133,591,768
Unearned stock compensation		(89,618)
Treasury stock, at cost, 1,126,113 and 1,196,463 shares	(18,851,921)	(20,042,947)
	-----	-----
Total stockholders' equity	116,653,793	113,459,203
	-----	-----
Total liabilities and stockholders' equity	\$145,003,088 =====	\$142,922,195 =====

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

DIGI INTERNATIONAL INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS  
FOR THE NINE MONTHS ENDED JUNE 30 2001 AND 2000  
(UNAUDITED)

	June 30, 2001	June 30, 2000
	-----	-----
Operating activities:		
Net income (loss)	\$ 2,058,937	\$ (9,751,250)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Asset impairment		18,068,249
Restructuring	(230,067)	(150,350)
Depreciation and amortization	3,242,338	4,199,379
Amortization of goodwill and acquired intangibles	3,920,006	6,229,613
Provision for losses on accounts receivable	524,504	540,268
Provision for inventory obsolescence	340,826	1,327,537
(Gain) loss on sale of fixed assets	(30,382)	9,253
Stock compensation	76,849	131,425
Changes in operating assets and liabilities	(7,131,209)	(1,767,624)
	-----	-----
Total adjustments	712,865	28,587,750
	-----	-----
Net cash provided by operating activities	2,771,802	18,836,500
	-----	-----
Investing activities:		
Purchase of marketable securities, net	(17,039,429)	(18,213,592)
Business acquisitions, net of cash acquired	(9,536,422)	
Purchase of property, equipment, intangibles and improvements	(1,289,808)	(2,211,512)
	-----	-----
Net cash used in investing activities	(27,865,659)	(20,425,104)
	-----	-----
Financing activities:		
(Payments) borrowing under lines of credit	(1,364,400)	1,653
Principal payments on long-term debt	(376,227)	(136,364)
Stock benefit plan transactions, net	1,107,243	1,376,904
	-----	-----
Net cash (used in) provided by financing activities	(633,384)	1,242,193
	-----	-----
Effect of exchange rate changes on cash and cash equivalents	91,382	(804,218)
Net decrease in cash and cash equivalents	(25,635,859)	(1,150,629)
Cash and cash equivalents, beginning of period	38,785,936	20,963,607
	-----	-----
Cash and cash equivalents, end of period	\$ 13,150,077	\$ 19,812,978
	=====	=====

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

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

1. BASIS OF PRESENTATION

The interim condensed consolidated financial statements included in this Form 10-Q have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures, normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted, pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in the Company's 2000 Annual Report on Form 10-K.

The condensed consolidated financial statements presented herein as of June 30, 2001, and for the three and nine months ended June 30, 2001 and 2000, reflect, in the opinion of management, all adjustments (which, other than the second quarter 2000 impairment loss, consist only of normal, recurring adjustments) necessary for a fair presentation of the consolidated financial position and the consolidated results of operations and cash flows for the periods presented. The consolidated results of operations for any interim period are not necessarily indicative of results for the full year.

2. ACQUISITIONS

On June 8, 2001, the Company acquired INXTECH, the parent company of Decision Europe, a French designer and manufacturer of data communications systems sold under the Xcell Technology brand. The transaction was accounted for using the purchase method of accounting. Accordingly, the initial purchase price of \$2,300,000, subject to possible post-closing adjustments based on the final value of INXTECH net assets, has been allocated to the estimated fair value of assets acquired and liabilities assumed.

The Company may be required to pay up to \$2,500,000 of additional cash consideration for the purchase subject to Decision Europe achieving certain future product development milestones and retention of certain key employees.

On October 2, 2000, the Company acquired Inside Out Networks (ION), a developer of data connections products based in Austin, Texas. The transaction was accounted for using the purchase method of accounting. Accordingly, the purchase price of \$7,550,844 has been allocated to the estimated fair value of assets acquired and liabilities assumed.

The Company may be required to pay up to \$8,500,000 of additional cash consideration for the purchase subject to ION achieving specific revenue and operating income targets during the three years following the acquisition.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## 2. ACQUISITIONS (CONTINUED)

The following unaudited pro forma condensed consolidated results of operations have been prepared as if the acquisition ION had occurred as of the beginning of the fiscal year ended September 30, 2000. The table below does not include results of operations of Decision Europe as those amounts are immaterial.

	Three months ended June 30, 2000 -----	Nine months ended June 30, 2000 -----
Net sales	\$33,125,008	\$100,883,116
Net income (loss)	2,210,052	(10,282,787)
Net income (loss) per share	\$ 0.15	\$ (0.68)

The unaudited pro forma condensed consolidated results of operations are not necessarily indicative of results that would have occurred had the acquisitions been in effect for the periods presented, nor are they necessarily indicative of results that will be obtained in the future.

## 3. RESTRUCTURING.

In September 2000, the Company's Board of Directors approved a restructuring plan related to its European operations headquartered in Dortmund, Germany, which provided for the transition of all product development, technical support and manufacturing functions to the Company's corporate headquarters located in Minnetonka, Minnesota. The plan also included the closure of the Company's office in Bagshot, England. The resulting charge of \$1,531,992 consisted of \$1,252,531 for severance and termination costs related to the elimination of 73 positions in Dortmund, Germany and 2 positions in Bagshot, England; \$134,227 related to the closure of the Bagshot office for lease cancellation; \$100,684 of cancellation fees related to automobile leases, maintenance contracts, and office equipment leases, and \$44,550 for severance-related legal expenses. Final facility closure costs and cancellation fees are expected to be paid during the fourth quarter of fiscal year 2001.

As of June 30, 2001, the Company had paid \$1,001,314 of termination costs relating to the elimination of 67 positions in Dortmund, Germany, and \$78,007 relating to the elimination of 2 positions in Bagshot, England. The Company paid \$134,227 of costs related to the Bagshot office closure during the nine months ended June 30, 2001. The Company paid \$67,068 for cancellation fees related to automobile leases, maintenance contracts, and office equipment leases during the nine months ended June 30, 2001. The remaining accruals for cancellation fees of \$21,309 relate to expected facility closure costs in Dortmund, Germany. Change in estimate adjustments related to the severance component of the restructuring accrual totaling \$173,210 were recorded in the second quarter of fiscal year 2001 because the Company made

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## 3. RESTRUCTURING (CONTINUED)

a decision to retain six employees who had previously been notified that they would be severed. In addition, change in estimate adjustments totaling \$12,307 and \$44,550, respectively, were recorded relating to the estimated cancellation fees and the legal costs components of the accrual. These change in estimate adjustments were reflected as a reduction in the restructuring accrual and a corresponding increase to operating income. A summary of payments and adjustments for the nine months ended June 30, 2001 is included in the table below.

Description	Balance at September 30, 2000	Payments	Change in Estimate Adjustments	Balance at June 30, 2001
Severance and termination costs	\$1,252,531	\$(1,079,321)	\$(173,210)	\$ --
Closure of Bagshot office	134,227	(134,227)	--	--
Cancellation fees	100,684	(67,068)	(12,307)	21,309
Severance-related legal expenses	44,550	--	(44,550)	--
TOTAL	\$1,531,992	\$(1,280,616)	\$(230,067)	\$21,309

## 4. INVENTORIES

Inventories are stated at the lower of cost or market, with cost determined on the first-in, first-out method. Inventories at June 30, 2001 and September 30, 2000 consisted of the following:

	June 30, 2001	Sept. 30, 2000
Raw materials	\$14,746,294	\$14,072,188
Work in process	1,080,655	1,092,654
Finished goods	4,515,360	4,535,168
	-----	-----
	\$20,342,309	\$19,700,010
	=====	=====



## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## 5. COMPREHENSIVE INCOME (LOSS)

The components of total comprehensive income (loss) are shown below. Comprehensive income (loss) includes net income (loss) and foreign currency translation adjustments that are charged or credited to stockholders' equity.

Comprehensive income (loss) for the three months and nine months ended June 30, 2001 and 2000 was as follows:

	Three months ended June 30		Nine months ended June 30	
	2001	2000	2001	2000
Net income (loss)	\$139,155	\$2,513,179	\$2,058,937	\$ (9,751,250)
Foreign currency translation adjustments	278,513	(114,662)	(74,292)	(1,196,988)
Comprehensive Income (loss)	<u>\$417,668</u>	<u>\$2,398,517</u>	<u>\$1,984,645</u>	<u>\$(10,948,238)</u>

## 6. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is calculated based on the weighted-average of common shares outstanding during the period. Net income (loss) per share, assuming dilution, is computed by dividing net income (loss) by the weighted-average number of common and common equivalent shares outstanding. The Company's only common equivalent shares are those that result from dilutive common stock options.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## 6. NET INCOME (LOSS) PER SHARE (CONTINUED)

The following table is a reconciliation of the numerators and denominators in the income (loss) per share calculations:

	Three months ended June 30			Nine months ended June 30		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>2001</b>						
<b>BASIC NET INCOME PER SHARE</b>						
Net income	\$ 139,155	15,243,716	\$0.01	\$ 2,058,937	15,206,085	\$ 0.14
<b>EFFECT OF DILUTIVE SECURITIES</b>						
Common equivalent shares	--	75,903	--	--	22,750	--
<b>DILUTED NET INCOME PER SHARE</b>						
Net income	\$ 139,155	15,319,619	\$0.01	\$ 2,058,937	15,228,835	\$ 0.14
<b>2000</b>						
<b>BASIC NET INCOME (LOSS) PER SHARE</b>						
Net income (loss)	\$2,513,179	15,095,436	\$0.17	\$(9,751,250)	15,041,935	\$(0.65)
<b>EFFECT OF DILUTIVE SECURITIES</b>						
Common equivalent shares	--	5,282	--	--	--	--
<b>DILUTED NET INCOME (LOSS) PER SHARE</b>						
Net income (loss)	\$2,513,179	15,100,718	\$0.17	\$(9,751,250)	15,041,935	\$(0.65)

Options to purchase 1,684,355 and 2,410,002 shares for the three and nine month periods ended June 30, 2001, and options to purchase 2,428,577 and 1,457,878 shares for the three and nine month periods ended June 30, 2000, were not included in the computation of diluted earnings per share because the exercise prices of these options was greater than the average market price of common shares and their effect would have been antidilutive.

## 7. RECENT ACCOUNTING DEVELOPMENTS

In December 1999, the Staff of the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 (SAB 101) - Revenue Recognition in Financial Statements. This SAB summarizes certain of the SEC's views regarding revenue recognition. The provisions of SAB 101, as amended by SAB 101A and SAB 101B, must be adopted by the fourth quarter of the Company's fiscal year ending September 30, 2001. However, any effects of the SAB must be reflected retroactively to October 1, 2000 (the first day of fiscal year 2001). The Company is reviewing the guidance outlined in SAB 101 and does not believe that the effect of adoption of SAB 101 will have a material impact on the Company's revenue recognition practices or its fiscal 2001 consolidated financial statements.

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards (SFAS) No. 141, "Business Combinations", and No. 142, "Goodwill and Other Intangible Assets." The most significant changes made by SFAS No. 141 are: 1) requiring that the purchase method of accounting be used for all business combinations initiated after

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## 7. RECENT ACCOUNTING DEVELOPMENTS (CONTINUED)

June 30, 2001, and 2) establishing specific criteria for the recognition of intangible assets separately from goodwill. SFAS No. 142 primarily addresses the accounting for acquired goodwill and intangible assets (i.e., the post-acquisition accounting). The provisions of SFAS No. 142 will be effective for fiscal years beginning after December 15, 2001. The most significant changes made by SFAS No. 142 are: 1) goodwill and indefinite-lived intangible assets will no longer be amortized; 2) goodwill and indefinite-lived intangible assets will be tested for impairment at least annually; and 3) the amortization period of intangible assets with finite lives will no longer be limited to forty years. Goodwill and intangible assets acquired after June 30, 2001, will be subject immediately to the nonamortization and amortization provisions of this statement. These standards only permit prospective application of the new accounting; accordingly, adoption of these standards will not affect previously reported financial information of the Company. The principal effect of SFAS No. 142 will be the Company ceasing the amortization of goodwill. Goodwill amortization was approximately \$3,030,000 for the year ended September 30, 2000, and approximately \$1,655,000 for the first nine months ended June 30, 2001.

## 8. LEGAL PROCEEDINGS

Discussion of legal matters is incorporated by reference from Part II, Item I of this Form 10-Q "Legal Proceedings" and should be considered an integral part of these Condensed Consolidated Financial Statements.

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

CONSOLIDATED RESULTS OF OPERATIONS

The following table sets forth selected information derived from the Company's interim consolidated consolidated statements of operations expressed as percentages of sales:

Cost of sales	48.0	46.9	(4.6)	47.7	47.5	(0.2)
	----	----	-----	----	----	-----
Gross margin	52.0	53.1	(8.7)	52.3	52.5	(1.1)
	----	----	-----	----	----	-----
Operating expenses:						
Sales and marketing	26.2	26.4	(7.6)	23.7	26.3	(10.4)
Research and development	15.3	14.1	0.6	14.6	15.9	(9.2)
General and administrative	11.6	12.0	(9.4)	12.2	15.2	(20.2)
Impairment loss	--	--	--	--	18.4	(100.0)
Restructuring	--	--	(97.5)	(0.2)	(0.2)	53.0
	----	----	-----	----	----	-----
Total operating expenses	53.1	52.5	(5.8)	50.3	75.6	(34.0)
	----	----	-----	----	----	-----
Operating (loss) income	(1.1)	0.6	(276.9)	2.0	(23.1)	(108.7)
Other income, net	2.0	2.3	(22.7)	2.1	10.1	(79.1)
	----	----	-----	----	----	-----
Income (loss) before income taxes	0.9	2.9	(72.5)	4.1	(13.0)	(131.5)
Income tax provision (benefit)	0.4	(4.9)	(107.7)	2.0	(3.1)	(164.2)
	----	----	-----	----	----	-----
Net income (loss)	0.5	7.8	(94.5)%	2.1	(9.9)	(121.1)%
	====	====	=====	====	=====	=====

NET SALES

Net sales for the three and nine months ended June 30, 2001 were lower than net sales for the corresponding three and nine months ended June 30, 2000, by \$2.2 million or 6.8%, and \$0.7 million or 0.7%, respectively. Net sales of the Company's legacy board products, including sales of acquired ION products and Decision Europe products, generated revenues of \$20.7 million for the third quarter of fiscal 2001 versus \$22.4 million for the comparable quarter last year, and \$65.5 million for the first nine months of fiscal 2001, compared to \$66.8 million for the first nine months of fiscal 2000. Physical layer local area network (LAN) products sales were \$5.6 million and \$18.1 million for the three and nine months ended June 30, 2001, reflecting increased revenues of \$2.4 million and \$9.3 million, respectively. Net sales of the Company's wide area network (WAN) products declined \$2.9 million and \$8.7 million for the three and nine-month periods ended June 30, 2001, versus the comparable periods a year ago.

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

NET SALES (CONTINUED)

The following table sets forth revenue by principal product group expressed as a percentage of net sales:

	Three months ended June 30		Nine months ended June 30	
	2001	2000	2001	2000
Server based	81.2%	90.1%	81.4%	91.1%
Physical layer	18.8	9.9	18.6	8.9
Total	100.0%	100.0%	100.0%	100.0%

GROSS MARGIN

Gross margin for the three and nine months ended June 30, 2001 was 52.0% and 52.3%, compared to 53.1% and 52.5% for the three and nine months ended June 30, 2000. The decrease in gross margin for the three and nine months ended June 30, 2001 compared to the comparable prior year periods ended June 30, 2000, is primarily due to unabsorbed fixed costs as a result of lower revenues. In addition, product mix changes had a negative impact on margins due to the impact of the increased proportion of sales of lower margin physical layer LAN products and the lower proportion of higher margin server-based communication products. The decrease in gross margin for the nine months ended June 30, 2001 compared to the comparable prior year period was not significant.

OPERATING EXPENSES

Operating expenses, excluding restructuring and asset impairment charges, for the three months ended June 30, 2001 decreased \$1.0 million, or 5.8%, compared to operating expenses for the three months ended June 30, 2000. Operating expenses for European operations decreased by \$1.3 million in the third quarter of fiscal 2001, which is primarily attributable to the restructuring which the Company executed in the fourth quarter of fiscal 2000. Operating expenses at the Company's Sunnyvale location increased by \$800,000 for the quarter ended June 30, 2001, compared to operating expenses for the three months ended June 30, 2000, primarily due to additional sales and marketing personnel and related expenses to support the \$2.4 million, or 75.0% increase in revenue for LAN products. The impact of incremental operating expenses of \$1.0 million related to the operations of ION, acquired in October 2000, and incremental operating expenses of \$.2 million related to Decision Europe, acquired in June 2001, were offset by the impact of cost containment measures at other locations resulting in expense reductions of \$1.7 million relative to the comparable quarter last year. Operating expenses, excluding restructuring and asset impairment charges, for the nine months ended June 30, 2001, decreased \$7.1 million, or

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

## OPERATING EXPENSES (CONTINUED)

12.7%, as compared to operating expenses for the nine months ended June 30, 2000. The fiscal 2000 European restructuring plan accounted for approximately \$7.3 million of the total decrease in operating expenses. Operating expenses increased by \$2.4 million in Sunnyvale primarily to support the \$9.3 million, or 105.7% increase in LAN product sales for the first nine months of fiscal 2001 as compared to the first nine months of fiscal 2000. In other locations additional savings of \$2.2 million were realized, due to a decrease in expenses of \$5.4 million as a result of cost containment measures across the Company that included a decrease in employee headcount of approximately 50 people from June 30, 2000 to June 30, 2001. The decrease in expenses due to the overall emphasis on cost containment was partially offset by the impact of incremental operating expenses of \$3.0 million and \$.2 million related to the operations of ION and Decision Europe, respectively, in the first nine months of fiscal 2001.

Sales and marketing expenses for the three and nine months ended June 30, 2001, were \$7.9 million and \$23.2 million, versus \$8.6 million and \$25.9 million in the comparable periods a year ago. The fiscal 2000 European restructuring resulted in expense reductions of \$0.4 million and \$2.1 million for the three and nine-month periods ended June 30, 2001, respectively. Additional expense reductions were achieved in travel and entertainment and cooperative advertising for the three and nine months ended June 30, 2001 compared to the same periods in the prior year. Incremental sales and marketing expenses related to the operations of ION for the three and nine-month periods ended June 30, 2001, were \$0.3 and \$0.7 million, respectively. Sales and marketing expenses at other locations decreased \$0.6 million and \$1.3 million for the three month and nine-month periods ended June 30, 2001, versus the comparable three and nine-month periods in the prior year, as a result of expense control measures taken in fiscal 2001.

Research and development expenses were \$4.6 million for each of the three-month periods ended June 30, 2001, and June 30, 2000. For the nine months ended June 30, 2001, research and development expenses were \$14.2 million, a decrease of \$1.4 million, or 9.2%, from the nine-month period ended June 30, 2000. The fiscal 2000 European restructuring resulted in expense reductions of \$0.5 million and \$1.5 million for the three and nine months ended June 30, 2001, respectively. Incremental research and development expenses related to the operations of ION for the three and nine-month periods ended June 30, 2001, were \$0.3 and \$0.7 million, respectively. Incremental research and development expenses related to the operations of Decision Europe for each of the three and nine-month periods ended June 30, 2001, were \$0.1 million. Compensation and other employee related expenses decreased by \$0.7 million for the nine-month period ended June 30, 2001, as a result of a reduction in engineering staffing. Expenses related to LAN product development in Sunnyvale increased \$0.1 million in each of the three and nine month periods ended June 30, 2001 over the comparable prior year periods due to a transition in product development to a newer group of products with a fiber connectivity focus.

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

## OPERATING EXPENSES (CONTINUED)

General and administrative expenses for the three months and nine months ended June 30, 2001, were \$3.5 million and \$11.9 million, versus \$3.9 million and \$14.9 million in the comparable periods a year ago. Included in the \$3.0 million decrease in general and administrative expenses for the nine months ended June 30, 2001 compared to the nine months ended June 30, 2000 is a \$2.3 million decrease in amortization of acquired intangibles. The decrease in amortization is due to the write off of certain ITK intangible assets in the second quarter of fiscal 2000 resulting in a reduction in amortization of \$3.4 million, partially offset by additional amortization of ION acquired intangibles of \$1.1 million. General and administrative expenses declined by \$0.4 million and \$3.6 million related to the fiscal 2000 European restructuring for the three and nine-month periods ended June 30, 2001, respectively. Incremental general and administrative expenses related to the operations of ION for the three and nine-month periods ended June 30, 2001, were \$0.5 million and \$1.6 million, respectively, of which \$0.4 million and \$1.1 million, respectively, resulted from amortization of acquired intangible assets. General and administrative expense reductions at other locations of \$0.5 million and \$1.0 million for the three and nine-month periods ended June 30, 2001, were realized due to expense control measures taken in fiscal 2001.

## OTHER INCOME (EXPENSE)

Other income for the three and nine months ended June 30, 2001 was \$0.6 million and \$2.1 million. The Company realized interest income on short-term marketable securities and cash and cash equivalents of \$0.7 million and \$2.5 million, respectively, for the three and nine months ended June 30, 2001. Interest expense on lines of credit and long term debt was \$0.1 million and \$0.5 million, respectively, for the three and nine-month periods ended June 30, 2001.

Other income for the three months and nine months ended June 30, 2000 was \$0.8 million and \$9.9 million. During the second fiscal quarter of 2000, the Company received an \$8.0 million payment from Nx Networks, the company which acquired AetherWorks Corporation. This represented payment in full of a non-convertible note receivable from AetherWorks (assumed by Nx Networks), previously recorded by the Company as having no carrying value, due to significant uncertainty as to its collectability. Other income also includes interest earned on cash and cash equivalents, partially offset by interest expense on line of credit borrowings and long-term debt.

## INCOME TAXES

Income taxes have been provided for at an estimated annual effective rate of 49% for the nine months ended June 30, 2001. This effective tax rate exceeds the U.S. statutory income tax

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

## INCOME TAXES (CONTINUED)

rate primarily due to the annual amortization expense relating to the goodwill acquired in the Central Data Corporation (CDC), Inside Out Networks, and Decision Europe acquisitions which is not deductible for income tax reporting purposes. For the nine months ended June 30, 2000, income taxes were provided for at an effective rate of 24% which was less than the U.S. statutory income tax rate primarily due to the reversal of certain deferred tax liabilities associated with ITK intangible assets that were written off in the second quarter of fiscal 2000.

## FINANCIAL CONDITION

## LIQUIDITY AND CAPITAL RESOURCES

The Company has financed its operations principally with funds generated from operations. The Company's working capital decreased from \$78.1 million at September 30, 2000, to \$77.6 million at June 30, 2001.

Net cash provided by operating activities was \$2.8 million for the nine months ended June 30, 2001, compared to net cash provided by operating activities of \$18.8 million for the nine months ended June 30, 2000. In March 2000, the Company received a one-time \$8.0 million payment on a note receivable from AetherWorks which had previously been recorded as uncollectable. There was also an additional \$5.4 million outflow of cash resulting from changes in operating assets and liabilities in the first nine months of fiscal 2001 compared to the first nine months of fiscal 2000. The net cash outflow of \$7.1 million relating to the change in operating assets and liabilities in the first nine months of fiscal 2001 relates primarily to a \$6.5 million increase in accounts receivable. The net cash outflow of \$1.8 million relating to the change in operating assets and liabilities in the first nine months of fiscal 2000 is primarily due to a decline of \$9.8 million in accounts receivable, offset by an increase in inventory of \$1.5 million and a decrease in accounts payable and accrued expenses of \$10.1 million.

Net cash used in investing activities for the nine months ended June 30, 2001, consisted of net purchases of marketable securities of \$17.0 million and \$1.3 million of purchases of equipment and other capital improvements. In October 2000, the Company acquired Inside Out Networks, resulting in a \$7.2 million use of cash. In June 2001, the Company used \$2.3 million to acquire Decision Europe.

For the nine months ended June 30, 2000, the Company had net purchases of marketable securities of \$18.2 million and used \$2.2 million for the purchase of equipment and capital improvements.

Net cash used for financing activities for the nine months ended June 30, 2001 consisted of \$1.1 million received from employee stock purchase plan transactions. The Company also made payments of \$1.7 million related to line of credit and debt obligations. For the nine months ended June 30, 2000, \$1.4 million was received as a result of employee stock benefit plan transactions, and \$135,000 was paid on line of credit and debt obligations.



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

FINANCIAL CONDITION (CONTINUED)

LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)

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

FOREIGN CURRENCY

Effective January 1, 1999, eleven countries of the European Union converted to a common currency called the "Euro." All invoicing activity within the European Union is required to be transacted in Euros, effective January 1, 2002. This action will cause some of the Company's European transactions to be negotiated, invoiced, and paid in Euros. Additional currency risk may exist when sales from the United States into the European Union are transacted in Euros rather than US dollars. Such costs and risks are not quantifiable at this time.

The Company continues to hold long-term debt denominated in Deutschemarks at its Dortmund, Germany (ITK) location, related to the facility in Dortmund. This debt balance is subject to fluctuations as a result of Deutschemark exchange rate changes.

For the three and nine months ended June 30, 2001, the Company had approximately \$8.7 million and \$28.7 million of net sales to foreign customers, respectively. For the three month period ended June 30, 2001, \$6.8 million was denominated in U.S. dollars and \$1.9 million was denominated in Deutschemarks. For the nine month period ended June 30, 2001, \$23.8 million was denominated in U.S. dollars and \$4.9 million was denominated in Deutschemarks.

In future periods, a significant portion of sales will be made in Deutschemarks until full integration of the Euro is achieved. The Company has not implemented a hedging strategy to reduce the risk of foreign currency translation exposures.

INFLATION

Management believes inflation has not had a material effect on the Company's operations or on its financial position.

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

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

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

## SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (CONTINUED)

Exchange Act of 1934, as amended. The words "believe," "expect," "anticipate," "intend," "estimate," "target," "may," "will," "plan," "project," "should," "continue," or the negative thereof or other expressions, which are predictions of or indicate future events and trends and which do not relate to historical matters, identify forward-looking statements. Such statements are based on information available to management as of the time of such statements and relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, perceived opportunities in the market and statements regarding the Company's mission and vision. Forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the actual results, performance or achievements of the Company to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. The Company undertakes no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

## RECENT ACCOUNTING DEVELOPMENTS

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 101, "Revenue Recognition in Financial Statements." The SAB summarizes certain of the SEC's views regarding revenue recognition. The provisions of SAB 101, as amended by SAB 101A and SAB 101B, must be adopted by the fourth quarter of the Company's fiscal year ending September 30, 2001. However, any effects of the SAB must be reflected retroactively to October 1, 2000 (the first day of fiscal year 2001). The Company is reviewing the guidance outlined in SAB 101 and does not believe the effect of adoption of SAB 101 will have a material impact on the Company's revenue recognition practices or its fiscal 2001 consolidated financial statements.

Effective October 1, 2000, the Company adopted Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FASB 133). The adoption of FASB 133 did not have an impact on the Company's consolidated financial position or results of operations as the Company does not have any derivative instruments nor does the Company participate in any hedging activities.

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards (SFAS) No. 141, "Business Combinations", and No. 142, "Goodwill and Other Intangible Assets." The most significant changes made by SFAS No. 141 are: 1) requiring that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, and 2) establishing specific criteria for the recognition of intangible assets separately from goodwill. SFAS No. 142 primarily addresses the accounting for acquired goodwill and intangible assets (i.e., the post-acquisition accounting). The provisions of SFAS No. 142 will be effective for fiscal years beginning after December 15, 2001. The most significant changes made by SFAS No. 142 are: 1) goodwill and indefinite-lived intangible assets will no longer be amortized; 2) goodwill and indefinite-lived intangible assets will be

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

RECENT ACCOUNTING DEVELOPMENTS (CONTINUED)

tested for impairment at least annually; and 3) the amortization period of intangible assets with finite lives will no longer be limited to forty years. Goodwill and intangible assets acquired after June 30, 2001, will be subject immediately to the nonamortization and amortization provisions of this statement. These standards only permit prospective application of the new accounting; accordingly, adoption of these standards will not affect previously reported financial information of the Company. The principal effect of SFAS No. 142 will be the Company's ceasing the amortization of goodwill. Goodwill amortization, was approximately \$3,030,000 for the year ended September 30, 2000, and approximately \$1,655,000 for the first nine months ended June 30, 2001.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company does not have material exposure to market risk from market risk sensitive financial instruments other than the currency risk associated with certain transactions being denominated in Deutschemarks.

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

Between January 3, 1997 and March 7, 1997, the Company and certain of its previous officers were named as defendants in putative securities class action lawsuits filed in the United States District Court for the District of Minnesota by 21 lead plaintiffs on behalf of an alleged class of purchasers of the Company's common stock during the period January 25, 1996 through December 23, 1996. The putative class actions were thereafter consolidated (Master File No. 97-5 DWF/RLE). The Consolidated Amended Class Action Complaint ("Consolidated Amended Complaint") alleges that the Company and certain of its previous officers violated the federal securities laws by, among other things, misrepresenting and/or omitting material information concerning the Company's operations and financial results.

On February 25, 1997, the Company and certain of its previous officers also were named as defendants in a securities lawsuit filed in the United States District Court for the District of Minnesota by the Louisiana State Employees Retirement System (Civil File No. 97-440, Master File No. 97-5 DWF/RLE) (the "Louisiana Amended Complaint"). The Louisiana Amended Complaint alleges that the Company and certain of its previous officers violated the federal securities laws and state common law by, among other things, misrepresenting and/or omitting material information concerning the Company's operations and financial results.

In a decision issued on May 22, 1998, the District Court dismissed without leave to replead all claims asserted in both cases, including all claims asserted against defendant Gary L. Deaner, except for certain federal securities law claims based upon alleged misrepresentations and/or omissions relating to the accounting treatment applied to the Company's AetherWorks investment. The District Court also limited the claims asserted in the Louisiana Amended Complaint to the 11,000 shares of the Company's stock held subsequent to November 14, 1996, for which the Louisiana Amended Complaint claims damages of \$184,276 and seeks an award of attorneys' fees, disbursements and costs. The Consolidated Amended Complaint seeks compensatory damages of approximately \$43.1 million, plus interest, against all defendants, jointly and severally, and an award of attorneys' fees, experts' fees and costs.

On August 17, 2000, the District Court granted defendants' motions for summary judgment and dismissed with prejudice the Consolidated Amended Complaint and the Louisiana Amended Complaint. Although the 21 lead plaintiffs in the consolidated putative class actions had previously moved for class certification, the District Court dismissed the actions before ruling on that motion. Both the Louisiana State Employees Retirement System and the 21 lead plaintiffs in the consolidated putative class actions filed appeals from the decisions of the District Court.

On July 5, 2001, the United States Court of Appeals for the Eighth Circuit affirmed the decisions of the District Court and ordered that judgment be entered in favor of defendants on the claims alleged in the Consolidated Amended Complaint and the Louisiana Amended Complaint. On July 19, 2001, the 21 lead plaintiffs in the consolidated putative class actions filed a petition for rehearing en banc with the Court of Appeals. No decision has yet been received on the petition.

The ultimate outcomes of these actions cannot be determined at this time, and no potential assessment of their effect, if any, on the Company's financial position, liquidity or future operations can be made.

PART II. OTHER INFORMATION (CONTINUED)

ITEM 2. CHANGES IN SECURITIES

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None

ITEM 5. OTHER INFORMATION

None

## PART II. OTHER INFORMATION (CONTINUED)

## ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

## (a) Exhibits:

Exhibit No. -----	Description -----
3(a)	Restated Certificate of Incorporation of the Registrant, as Amended (1)
3(b)	Amended and Restated By-Laws of the Registrant (2)
4(a)	Form of Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (3)
4(b)	Amendment dated January 26, 1999, to Share Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (4)

## (b) Reports on Form 8-K:

There were no reports on Form 8-K for the quarterly period ended June 30, 2001.

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- (1) Incorporated by reference to Exhibit 3(a) to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972)
  - (2) Incorporated by reference to Exhibit 3(b) to the Company's Registration Statement on Form S-1 (File No. 33-42384)
  - (3) Incorporated by reference to Exhibit 1 to the Company's Registration Statement on Form 8-A dated June 24, 1998 (File No. 0-17972)
  - (4) Incorporated by reference to Exhibit 1 to Amendment 1 to the Company's Registration Statement on Form 8-A dated February 5, 1999 (File No. 0-17972)

SIGNATURE

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

DIGI INTERNATIONAL INC.

Date: August 14, 2001

By: /s/ S. Krishnan

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S. Krishnan  
Chief Financial Officer  
(duly authorized officer and  
Principal Financial Officer)

## EXHIBIT INDEX

Exhibit Number	Document Description	Form of Filing
3(a)	Restated Certificate of Incorporation of the Registrant, as Amended (incorporated by reference to the corresponding exhibit number to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972).....	Incorporated by Reference
3(b)	Amended and Restated By-Laws of the Registrant (incorporated by reference to the corresponding exhibit number to the Company's Registration Statement on Form S-1 (File No. 33-42384).....	Incorporated by Reference
4(a)	Form of Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (incorporated by reference to Exhibit 1 to the Company's Registration Statement on Form 8-A dated June 24, 1998 (File No. 0-17972).....	Incorporated by Reference
4(b)	Amendment dated January 26, 1999, to Share Rights Agreement, dated June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (incorporated by reference to Exhibit 1 to Amendment No. 1 to the Company's Registration Statement on Form 8-A dated February 5, 1999 (File No. 0-17972)).....	Incorporated by Reference