
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, 1997.

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

(State or other jurisdiction of
incorporation or organization)

41-1532464

(I.R.S. Employer
Identification Number)

11001 Bren Road East

Minnetonka, Minnesota 55343

(Address of principal executive offices) (Zip Code)

(612) 912-3444

(Registrant's telephone number, including area code)

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

Yes No

On June 30, 1997, there were 13,406,963 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 STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS AND NINE MONTHS ENDED JUNE 30, 1997 AND 1996
(UNAUDITED)

| | Three months ended June 30 | | Nine months ended June 30 | |
|---|----------------------------|--------------------|---------------------------|---------------------|
| | 1997 | 1996 | 1997 | 1996 |
| Net sales | \$ 40,843,298 | \$ 49,642,710 | \$ 123,472,736 | \$ 141,332,248 |
| Cost of sales | <u>20,724,950</u> | <u>25,191,439</u> | <u>64,419,895</u> | <u>67,760,818</u> |
| Gross margin | <u>20,118,348</u> | <u>24,451,271</u> | <u>59,052,841</u> | <u>73,571,430</u> |
| Operating expenses: | | | | |
| Sales and marketing | 9,112,452 | 12,510,890 | 29,310,308 | 31,023,175 |
| Research and development | 3,938,589 | 5,593,164 | 14,284,202 | 14,472,114 |
| General and administrative | 4,523,797 | 4,381,571 | 13,964,227 | 11,163,649 |
| Restructuring | <u>-</u> | <u>-</u> | <u>10,471,482</u> | <u>-</u> |
| Total operating expenses | <u>17,574,838</u> | <u>22,485,625</u> | <u>68,030,219</u> | <u>56,658,938</u> |
| Operating income (loss) | 2,543,510 | 1,965,646 | (8,977,378) | 16,912,492 |
| Other income (expense), net | 117,221 | (149,794) | 343,456 | 394,841 |
| AetherWorks Corporation net loss | <u>(1,525,006)</u> | <u>(1,203,625)</u> | <u>(4,634,476)</u> | <u>(2,138,922)</u> |
| Income (loss) before income taxes | 1,135,725 | 612,227 | (13,268,398) | 15,168,411 |
| Provision (benefit) for income taxes | <u>1,068,455</u> | <u>663,457</u> | <u>(1,357,450)</u> | <u>6,078,106</u> |
| Net income (loss) | <u>\$ 67,270</u> | <u>\$ (51,230)</u> | <u>\$ (11,910,948)</u> | <u>\$ 9,090,305</u> |
| Net income (loss) per common and common equivalent share | <u>\$ 0.01</u> | <u>\$ -</u> | <u>\$ (0.89)</u> | <u>\$ 0.66</u> |
| Weighted average common and common equivalent shares outstanding | <u>13,403,895</u> | <u>13,841,154</u> | <u>13,379,899</u> | <u>13,828,104</u> |

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

DIGI INTERNATIONAL INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

| ASSETS | June 30 1997 | September 30 1996 |
|--|-----------------------|-----------------------|
| Current assets: | (unaudited) | |
| Cash and cash equivalents | \$ 14,793,019 | \$ 8,943,390 |
| Accounts receivable, net | 34,239,782 | 42,874,898 |
| Inventories | 27,989,600 | 33,372,164 |
| Income tax refund receivable | 1,746,720 | 1,675,626 |
| Other | <u>2,458,798</u> | <u>2,825,828</u> |
| Total current assets | 81,227,919 | 89,691,906 |
| Property, equipment and improvements, net | 22,940,693 | 24,230,101 |
| Intangible assets, net | 7,173,228 | 10,854,845 |
| Investment in AetherWorks Corporation | 2,038,273 | 1,672,749 |
| Other | <u>1,615,684</u> | <u>3,489,228</u> |
| Total assets | <u>\$ 114,995,797</u> | <u>\$ 129,938,829</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 9,409,245 | \$ 12,549,738 |
| Accrued expenses: | | |
| Advertising | 3,016,874 | 3,761,619 |
| Compensation | 1,340,604 | 1,622,549 |
| Restructuring | 579,163 | - |
| Other | <u>1,982,476</u> | <u>2,061,782</u> |
| Total current liabilities | 16,328,362 | 19,995,688 |
| 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; 14,694,456 and 14,677,150 shares issued | 146,945 | 146,772 |
| Additional paid-in capital | 44,495,675 | 42,866,758 |
| Retained earnings | <u>78,993,794</u> | <u>90,904,746</u> |
| | 123,636,414 | 133,918,276 |
| Unearned stock compensation | (2,097,680) | (295,156) |
| Treasury stock, at cost, 1,288,026 and 1,338,894 shares | <u>(22,871,299)</u> | <u>(23,679,979)</u> |
| Total stockholders' equity | 98,667,435 | 109,943,141 |
| Total liabilities and stockholders' equity | <u>\$ 114,995,797</u> | <u>\$ 129,938,829</u> |

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

DIGI INTERNATIONAL INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED JUNE 30, 1997 AND 1996
(UNAUDITED)

| | 1997 | 1996 |
|--|-----------------|--------------|
| Operating activities: | | |
| Net (loss) income | \$ (11,910,948) | 9,090,305 |
| Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities: | | |
| Restructuring | 9,600,666 | - |
| Depreciation and amortization | 5,256,247 | 3,654,134 |
| AetherWorks Corporation net loss | 4,634,476 | 2,138,922 |
| Loss on sale of fixed assets | 172,304 | - |
| Provision for doubtful accounts receivable | 1,062,936 | 323,838 |
| Provision for inventory obsolescence | 2,256,514 | 1,263,200 |
| Stock compensation | 105,177 | 158,031 |
| Changes in operating assets and liabilities | 3,622,585 | (24,059,735) |
| Total adjustments | 26,710,905 | (16,521,610) |
| Net cash provided by (used in) operating activities | 14,799,957 | (7,431,305) |
| Investing activities: | | |
| Purchase of property, equipment, intangibles, and improvements | (4,480,397) | (11,417,259) |
| Investment in AetherWorks Corporation | (5,000,000) | (4,796,525) |
| Sale of marketable securities, net | - | 27,968,775 |
| Net cash (used in) provided by investing activities | (9,480,397) | 11,754,991 |
| Financing activities: | | |
| Stock benefit plan transactions, net | 530,069 | 1,453,790 |
| Purchase of treasury stock | - | (7,249,339) |
| Net cash provided by (used in) financing activities | 530,069 | (5,795,549) |
| Net increase (decrease) in cash and cash equivalents | 5,849,629 | (1,471,863) |
| Cash and cash equivalents, beginning of period | 8,943,390 | 5,103,731 |
| Cash and cash equivalents, end of period | \$ 14,793,019 | \$ 3,631,868 |

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. Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles, 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 1996 Annual Report and Form 10-K.

The condensed consolidated financial statements presented herein as of June 30, 1997 and for the three and nine month periods ended June 30, 1997 and 1996, reflect, in the opinion of management, all adjustments (which, with the exception of the restructuring charge, 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. INVESTMENT IN AETHERWORKS CORPORATION

Through June 30, 1997, under a financing arrangement, the Company purchased \$10,296,525 of convertible notes from AetherWorks Corporation, a development stage company engaged in the development of wireless and dial-up remote access technology. At June 30, 1997, the Company is obligated to purchase up to an additional \$3.5 million of convertible notes from time to time at the request of AetherWorks, based on certain conditions. The convertible notes held by the Company at June 30, 1997 are convertible into 58.2% of AetherWorks' common stock, and upon the purchase of the additional \$3.5 million of convertible notes, the Company's ownership interest upon conversion would increase to 62.7%, based on AetherWorks' present capitalization. In connection with the financing arrangement, the Company has also guaranteed \$2.8 million of lease obligations of AetherWorks.

The Company has reported its investment in AetherWorks on the equity method and has reported losses of \$1,525,006 and \$4,634,476 for the three month and nine month periods ended June 30, 1997, and recorded losses of \$1,203,625 and \$2,138,922 for the corresponding three and nine month periods ended June 30, 1996. Such losses represent 100% of the AetherWorks net losses for these periods. The percentage of AetherWorks' net losses included in the Company's financial statements is based upon the percentage of financial support provided by the Company (versus other investors) to AetherWorks during such periods.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

2. INVESTMENT IN AETHERWORKS CORPORATION (CONTINUED)

Investment in AetherWorks Corporation consisted of the following:

| | <u>June 30, 1997</u> | <u>September 30, 1996</u> |
|------------------------------|----------------------|---------------------------|
| Convertible notes receivable | \$10,296,525 | \$5,296,525 |
| Cumulative net losses | <u>(8,258,252)</u> | <u>(3,623,776)</u> |
| | <u>\$2,038,273</u> | <u>\$1,672,749</u> |

3. 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, 1997 and September 30, 1996 consisted of the following:

| | <u>June 30, 1997</u> | <u>September 30, 1996</u> |
|-----------------|----------------------|---------------------------|
| Raw materials | \$13,787,559 | \$19,145,019 |
| Work in process | 7,695,630 | 10,469,315 |
| Finished goods | 6,506,411 | 3,757,830 |

4. INCOME (LOSS) PER SHARE

Net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common and common equivalent shares outstanding during each period. Common stock equivalents result from dilutive stock options. Common stock equivalents were excluded in determining the weighted average common and common stock equivalents outstanding for the three and nine month periods ended June 30, 1997, because their effect would be antidilutive.

In February 1997, the Financial Accounting Standards Board issued Statement No. 128 "Earnings Per Share." This Statement establishes standards for computing and presenting basic and diluted earnings per share (EPS) for financial statements issued for both interim and annual periods ending after December 15, 1997. The adoption of this Statement will not have a material effect on the Company's reported EPS.

5. RESTRUCTURING CHARGE

During the previous quarter ended March 31, 1997, the Company's Board of Directors approved a restructuring plan which resulted in a restructuring charge of \$10,471,482 (\$8,283,681, net of tax benefits or \$0.62 per share). The restructuring charge related to the closing of the Cleveland manufacturing facility, the reduction of selected product lines and the consolidation and closing of certain research and development facilities. These costs included (i) write downs of the carrying values of fixed assets related to the closed manufacturing and research and development facilities, (ii) write downs of the carrying values of goodwill and identifiable intangible assets (primarily licensing agreements related to the discontinued product lines) and related inventories and (iii) the

accrual of severance costs associated with the elimination of 105 positions (total workforce reduction was 150).

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

5. RESTRUCTURING CHARGE (CONTINUED)

The restructuring charge consists of \$1,449,979 in cash expenditures (primarily severance), of which \$870,816 had been paid as of June 30, 1997, and \$9,021,503 resulting from the write down of asset carrying values. As of June 30, 1997, \$9,892,319 had been charged to this restructuring reserve and the remaining reserve of \$579,163 is expected to be essentially utilized during fiscal 1997.

6. RECLASSIFICATION OF CERTAIN EXPENSES

Rebates to customers of approximately \$673,862 and \$1,348,862 for the three and nine month periods ended June 30, 1996, now reflected as a reduction of sales, were previously included in sales and marketing expenses. This reclassification had no impact on previously reported operating income (loss), or net income (loss).

In addition, certain costs relating to systems support and communication costs, which previously were included in general and administrative expenses have been reclassified into sales and marketing and research and development expenses for all periods presented. Such amounts were \$677,071 and \$1,993,693 for the three and nine month periods ended June 30, 1997 and \$692,226 and \$2,014,798 for the three and nine month periods ended June 30, 1996, respectively. These reclassifications had no impact on previously reported operating income (loss), or net income (loss).

7. 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 Consolidated Condensed Financial Statements and Accompanying Notes.

8. EMPLOYEE STOCK OPTIONS

During the fiscal quarter ended June 30, 1997, the Company cancelled and reissued stock options to certain employees to purchase shares of the Company's stock at an exercise price of \$8.00 per share. In connection with this transaction, the Company recorded approximately \$1.9 million of unearned compensation which will be amortized into operations over the vesting period of four years commencing May 8, 1997.

REVIEW REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders and Board of Directors of
Digi International Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Digi International Inc. and subsidiaries as of June 30, 1997, and the related condensed consolidated statements of operations for the three month and nine month periods ended June 30, 1997 and 1996 and cash flows for the nine month periods ended June 30, 1997 and 1996. These condensed consolidated financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheet as of September 30, 1996, and the related consolidated statements of operations and cash flows for the year then ended (not presented herein); and in our report dated December 20, 1996, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of September 30, 1996, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ COOPERS & LYBRAND L.L.P.

Minneapolis, Minnesota
July 23, 1997

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 condensed consolidated statements of operations expressed as percentages of sales:

| | Three months | | % | Nine months | | % |
|--------------------------------------|--------------|--------------|----------------|--------------|--------------|----------------|
| | ended | | Increase | ended | | Increase |
| | June 30 | | (decrease) | June 30 | | (decrease) |
| | <u>1997</u> | <u>1996</u> | | <u>1997</u> | <u>1996</u> | |
| Net sales | 100.0% | 100.0% | (17.7%) | 100.0% | 100.0% | (12.6%) |
| Cost of sales | <u>50.7</u> | <u>50.7</u> | <u>(17.7)</u> | <u>52.2</u> | <u>47.9</u> | <u>4.9</u> |
| Gross margin | <u>49.3</u> | <u>49.3</u> | <u>(17.7)</u> | <u>47.8</u> | <u>52.1</u> | <u>(19.7)</u> |
| Operating expenses: | | | | | | |
| Sales and marketing | 22.3 | 25.2 | (27.2) | 23.7 | 22.0 | (5.5) |
| Research and development | 9.6 | 11.3 | (29.6) | 11.6 | 10.2 | (1.3) |
| General and administrative | 11.1 | 8.8 | 3.2 | 11.3 | 7.9 | 25.1 |
| Restructuring | <u>0.0</u> | <u>0.0</u> | <u>100.0</u> | <u>8.5</u> | <u>0.0</u> | <u>100.0</u> |
| Total operating expenses | <u>43.0</u> | <u>45.3</u> | <u>(21.8)</u> | <u>55.1</u> | <u>40.1</u> | <u>20.1</u> |
| Operating income (loss) | 6.2 | 4.0 | 29.4 | (7.3) | 12.0 | (153.1) |
| Other income (expense), net | 0.3 | (0.3) | (178.3) | 0.3 | 0.3 | (13.0) |
| AetherWorks Corporation net loss | <u>(3.7)</u> | <u>(2.4)</u> | <u>26.7</u> | <u>(3.8)</u> | <u>(1.5)</u> | <u>116.7</u> |
| Income (loss) before income taxes | 2.8 | 1.2 | 85.5 | (10.7) | 10.7 | (187.5) |
| Provision (benefit) for income taxes | <u>2.6</u> | <u>1.3</u> | <u>61.0</u> | <u>(1.1)</u> | <u>4.3</u> | <u>(122.3)</u> |
| Net income (loss) | <u>0.2</u> | <u>(0.1)</u> | <u>(231.3)</u> | <u>(9.6)</u> | <u>6.4</u> | <u>(231.0)</u> |

NET SALES

Sales for the three month and nine month periods ended June 30, 1997 were lower than sales for the corresponding periods ended June 30, 1996 by \$8,799,412 and \$17,859,512 or 17.7% and 12.6%, respectively. The majority of decline was primarily due to a conscious effort by the Company to reduce inventory levels in the distribution channel in the three month periods ended March 31, 1997 and June 30, 1997 and softness in demand for networking products during the first quarter of fiscal 1997. In addition, sales for the three month and nine month periods ended June 30, 1997 were also reduced by customer rebates of \$1,093,925 and \$3,078,925, respectively, an increase in such rebates of \$420,063 and \$1,730,063, respectively, over the corresponding periods ended June 30, 1996. Such increases were due to providing incentives to the distribution market.

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

CONSOLIDATED RESULTS OF OPERATIONS (CONTINUED)

NET SALES (CONTINUED)

Net sales to Original Equipment Manufacturers (OEMs), as a percentage of total net sales, rose to 26.1% and 23.6% for the three and nine month periods ended June 30, 1997, as compared to 22.5% and 19.4% for the comparable periods in 1996. Sequentially, net sales to OEMs for the three month period ended June 30, 1997 increased 5.1% as compared to the three month period ended March 31, 1997. The increase for the three month period was due primarily to seasonal replenishment by OEM customers. The Company expects the OEM portion of the Company's business to remain relatively stable with the current level in the fourth quarter.

Net sales from the distribution markets, as a percentage of total sales, declined to 61.5% and 63.7% for the three month and nine month periods ended June 30, 1997, as compared to 63.9% and 66.1% for the comparable periods for 1996. Sequentially, sales from the distribution market for the three month period ended June 30, 1997 increased 2.8%, as compared to the three month period ended March 31, 1997.

The effort by the Company to reduce inventory levels in the distribution channel is expected to continue in the fourth quarter of fiscal 1997 and into the first quarter of fiscal 1998.

GROSS MARGIN

Gross margin for the three month period ended June 30, 1997 remained flat at 49.3%, as compared to the three month period ended June 30, 1996. Gross margin for the nine month period ended June 30, 1997 declined to 47.8%, as compared to 52.1% for the comparable period in 1996. Such decline was principally due to the increase of OEM and physical layer product net sales as a percentage of total net sales. OEM and physical layer products generally provide lower gross margins, as compared to sales of multi-connect and remote access products. In addition, the Company has increased its reserves for excess and obsolete inventories by approximately \$993,000 in the nine months ended June 30, 1997 versus 1996.

OPERATING EXPENSES

Operating expenses for the three month period ended June 30, 1997 declined 21.8% over operating expenses for the corresponding period ended June 30, 1996 and decreased as a percentage of sales to 43.0% for the three month period ended June 30, 1997 from 45.3% for the three month period ended June 30, 1996. Operating expenses for the nine month period ended June 30, 1997 increased by 20.1% over the corresponding period ended June 30, 1996, and increased as a percentage of sales to 55.1% for the nine month period ended June 30, 1997,

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

CONSOLIDATED RESULTS OF OPERATIONS (CONTINUED)

OPERATING EXPENSES (CONTINUED)

from 40.1% for the corresponding period in 1996. These increases were due principally to the restructuring charge of \$10.5 million, recorded in the three month period ended March 31, 1997. The restructuring charge related to the closing of the Cleveland manufacturing facility, the elimination of selected product lines and the consolidation and closing of certain research and development facilities. These costs included (i) write downs of the carrying values of fixed assets related to the closed manufacturing and research and development facilities, (ii) write downs of the carrying values of goodwill and identifiable intangible assets (primarily licensing agreements related to the discontinued product lines) and related inventories and (iii) the accrual of severance costs associated with the elimination of 105 positions (total workforce reduction was 150).

Sales and marketing, research and development and general and administrative costs declined from \$21.4 million and \$18.6 million in the three month periods ended December 31, 1996 and March 31, 1997, respectively, to \$17.6 million in the three month period ended June 30, 1997. Such decline was due to decreased marketing costs and a reduction of funding levels for new product development. The Company expects to continue to reduce such costs during the fourth quarter of fiscal 1997.

OTHER INCOME (EXPENSE), NET

Other income (expense), net for the three and nine month periods ended June 30, 1997 amounted to \$117,221 and \$343,456, respectively, as compared to other expense, net of \$149,794 and other income, net of \$394,841 for the corresponding periods in 1996. The decline for the nine month period was due to lower interest income resulting from a decrease in invested funds. The increase for the three month period ended June 30, 1997 was a result of increased cash balances and an ability to invest more funds.

AETHERWORKS CORPORATION NET LOSS

In connection with the purchase of convertible notes from AetherWorks Corporation, a development stage company engaged in the development of wireless and dial-up remote access technology, the Company has the ability, under certain conditions, to convert its investment into a majority of AetherWorks' common stock. The Company has reported its investment in AetherWorks on the equity method and has recorded \$1,525,006 and \$4,634,476 of net losses for

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

CONSOLIDATED RESULTS OF OPERATIONS (CONTINUED)

AETHERWORKS CORPORATION NET LOSS (CONTINUED)

the three and nine month periods ended June 30, 1997, respectively. The Company recorded AetherWorks net losses of \$1,203,625 and \$2,138,922 for the corresponding three and nine month periods ended June 30, 1996. These net losses represent 100% of AetherWork's net losses for such periods. The percentage of AetherWorks' net losses included in the Company's financial statements is based upon the percentage of financial support provided by the Company (versus other investors) to AetherWorks during such periods. The Company anticipates that AetherWorks' net losses for the remainder of fiscal 1997 will be at levels similar to or higher than those incurred during the three and nine month periods ended June 30, 1997.

INCOME TAXES

Due to the net losses incurred in the nine month period ended June 30, 1997, the Company has recorded an income tax benefit of \$1,357,450. Such benefit is not higher due to the non-deductibility of certain intangible assets written off as part of the restructuring charge and the AetherWorks net losses. During the three month period ended June 30, 1997, the Company had taxable income (due to the non-deductibility of the AetherWorks net losses) and, accordingly, has recorded an income tax provision of \$1,068,455.

FINANCIAL CONDITION

LIQUIDITY AND CAPITAL RESOURCES

The Company has financed its operations principally with funds generated from operations and proceeds from earlier public offerings. Investing activities for the three and nine month periods ended June 30, 1997, consisted of purchases of equipment and capital improvements, including a new enterprise wide computer system, and the purchase of additional convertible notes from AetherWorks Corporation. Such notes purchases totaled \$1.5 million and \$5.0 million in the three and nine month periods ended June 30, 1997, respectively. As of June 30, 1997, the Company is obligated to purchase up to an additional \$3.5 million in convertible notes from time to time at the request of AetherWorks. See also Note 2 of the Notes to the Condensed Consolidated Financial Statements.

At June 30, 1997, the Company had working capital of \$64,899,557 million and no debt. The Company has negotiated a \$5 million unsecured line of credit with its bank, but has not utilized such line. The Company's management believes that current financial resources, cash generated from operations and the Company's potential capacity for debt and/or equity financing will be sufficient to fund current and anticipated business operations, including the Company's obligation to purchase additional convertible notes from AetherWorks Corporation.

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

FINANCIAL CONDITION (CONTINUED)

FOREIGN CURRENCY TRANSLATION

Substantially all of the Company's foreign transactions are negotiated, invoiced and paid in U.S. dollars.

INFLATION

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

FORWARD LOOKING STATEMENTS

Certain statements made above, which are summarized below, are forward-looking statements that involve risks and uncertainties, and actual results may be materially different. Factors that could cause actual results to differ include those identified below:

The expectation that the OEM portion of the Company's business will remain relatively stable with the current level in the fourth quarter. This expectation may be impacted by unanticipated revenue opportunities or changes in ordering levels that may reduce current levels of net sales to OEMs.

The effort to reduce inventory levels in the distribution channel is expected to continue in the fourth quarter. General market conditions and competitive conditions within these markets may impact sales levels either unfavorably or favorably.

The expectation that lower sales levels are anticipated to continue into the fourth quarter of 1997 and into the first quarter of fiscal 1998. General market conditions and competitive conditions within these markets may impact sales levels either unfavorably or favorably.

The expectation that the reduction in sales and marketing, research and development and general and administrative costs will continue during the fourth quarter of fiscal 1997. This expectation may be impacted by presently unanticipated revenue opportunities or by unanticipated expenses.

The expectation that the AetherWorks Corporation net losses for the remainder of fiscal 1997 will be similar or greater than those incurred during the three and nine month periods ended June 30, 1997. This expectation may be impacted by presently unanticipated revenue opportunities or by unanticipated expenses.

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

FINANCIAL CONDITION (CONTINUED)

FORWARD LOOKING STATEMENTS (CONTINUED)

The belief that the Company's current financial resources, cash generated from operations and the Company's potential capacity for debt and/or equity financing will be sufficient to fund current and anticipated business operations. Changes in anticipated operating results, credit availability and equity market conditions may further enhance or inhibit the Company's ability to maintain or raise appropriate levels of cash.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On January 3, 1997, the Company and certain of its previous officers were named as defendants in a putative securities class action lawsuit in the United States District Court for the District of Minnesota on behalf of an alleged class of purchasers of its common stock during the period January 25, 1996, through December 23, 1996. Between January 17, 1997 and March 7, 1997, four similar putative securities class actions also were commenced. By Memorandum and Order dated April 2, 1997, the District Court consolidated all five of the putative securities class actions for all purposes including trial, appointed 21 persons to serve as lead plaintiffs in the consolidated class actions, and allowed the lead plaintiffs to file and serve a consolidated class action complaint.

On May 12, 1997, a consolidated amended class action complaint (the “Consolidated Amended Complaint”) was filed in the combined actions, which are captioned In re Digi International Inc. Securities Litigation, Master File No. 97-5 (JRT/RLE) (U.S. District Court for the District of Minnesota). The Consolidated Amended Complaint alleges that the Company and its previous officers Ervin F. Kamm, Jr., Gerald A. Wall and Gary L. Deaner violated the federal securities laws by, among other things, misrepresenting and/or omitting material information concerning the Company’s operations and financial results. The Consolidated Amended Complaint seeks compensatory damages in an unspecified amount plus interest against all defendants, jointly and severally, and an award of attorneys’ fees, experts’ fees and costs.

On July 3, 1997, defendants served a motion to dismiss the Consolidated Amended Complaint on the ground, among others, that it fails to plead claims in accordance with applicable law. The briefing with respect to this motion is expected to be completed by August 1997, with a hearing before the District Court to be scheduled thereafter.

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 and entitled Louisiana State Employees Retirement System in behalf of itself and in behalf of all other parties similarly situated and circumstanced who desire to personally join in this action and to contribute to the costs and expenses thereof, Plaintiffs, vs. Digi International Inc., Gary L Deaner, Ervin F. Kamm, Jr., Gerald A. Wall, and “John Doe and “Richard Roe”, the names “John Doe” and “Richard Roe” being fictitious, the parties intended being those parties, presently unknown to the plaintiff, who participated in the wrongful acts set forth herein, Defendants, Civil File No. 97-440, Master File No. 97-5 (JRT/RLE) (U.S. District Court for the District of Minnesota). On June 3, 1997, the Louisiana State Employees Retirement System filed an Amended Complaint (the “Louisiana Amended Complaint”). The Louisiana Amended Complaint alleges that the Company and its previous officers Ervin F. Kamm, Jr., Gerald A. Wall and Gary L. Deaner violated 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.

PART II. OTHER INFORMATION (CONTINUED)

ITEM 1. LEGAL PROCEEDINGS (CONTINUED)

The Louisiana Amended Complaint seeks compensatory damages in the amount of \$718,404.70 plus interest against all defendants, jointly and severally, and an award of attorneys' fees, disbursements and costs. This action has been consolidated with the consolidated class actions for pretrial purposes.

On July 17, 1997, defendants served a motion to dismiss the Louisiana Amended Complaint on the ground, among others, that it fails to plead claims in accordance with applicable law. The briefing with respect to this motion is expected to be completed by August 1997, with a hearing before the District Court to be scheduled thereafter.

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

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

| Exhibit No. | Description |
|-------------|--|
| 3(a) | Amended and Restated Certificate of Incorporation of the Registrant* |
| 3(b) | Amended and Restated By-Laws of the Registrant** |
| 15 | Letter Re: Unaudited Interim Financial Information |
| 27 | Financial Data Schedule |

(b) Reports on Form 8-K:

None.

*Incorporated by reference to the corresponding exhibit number of the Company's Form 10-K for the year ended September 30, 1992 (File No. 0-017972)

**Incorporated by reference to the corresponding exhibit number of the Company's Registration Statement on Form S-1 (File No. 33-42384)

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 11, 1997

By: /s/ Jonathon E. Killmer

Jonathon E. Killmer
Chief Financial Officer
(duly authorized officer and
Principal Financial Officer)