

DIGI INTERNATIONAL INC
Form 10-Q
July 31, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended: June 30, 2015

OR

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

For the transition period from _____ to _____

Commission file number: 1-34033

DIGI INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

Delaware

41-1532464

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

11001 Bren Road East

Minnetonka, Minnesota

55343

(Address of principal executive offices)

(Zip Code)

(952) 912-3444

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer 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

On July 28, 2015, there were 24,985,341 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.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

| | Three months ended June 30, | | Nine months ended June 30, | | |
|-----------------------------------|--|----------|----------------------------|-----------|---|
| | 2015 | 2014 | 2015 | 2014 | |
| | (in thousands, except per common share data) | | | | |
| Revenue: | | | | | |
| Hardware product | \$50,001 | \$43,303 | \$143,042 | \$125,852 | |
| Service | 4,537 | 4,582 | 13,370 | 15,237 | |
| Total revenue | 54,538 | 47,885 | 156,412 | 141,089 | |
| Cost of sales: | | | | | |
| Cost of hardware product | 25,729 | 21,587 | 74,339 | 61,862 | |
| Cost of service | 3,460 | 4,149 | 10,724 | 12,390 | |
| Total cost of sales | 29,189 | 25,736 | 85,063 | 74,252 | |
| Gross profit | 25,349 | 22,149 | 71,349 | 66,837 | |
| Operating expenses: | | | | | |
| Sales and marketing | 9,434 | 9,859 | 30,525 | 30,477 | |
| Research and development | 8,374 | 7,253 | 23,715 | 21,921 | |
| General and administrative | 4,720 | 5,317 | 14,448 | 14,659 | |
| Restructuring charges, net | (9 |) — | 509 | 81 | |
| Total operating expenses | 22,519 | 22,429 | 69,197 | 67,138 | |
| Operating income (loss) | 2,830 | (280 |) 2,152 | (301 |) |
| Other income (loss), net: | | | | | |
| Interest income, net | 42 | 35 | 134 | 127 | |
| Other income (loss), net | 419 | (69 |) 2,131 | 45 | |
| Total other income (loss), net | 461 | (34 |) 2,265 | 172 | |
| Income (loss) before income taxes | 3,291 | (314 |) 4,417 | (129 |) |
| Income tax provision (benefit) | 795 | (213 |) 814 | (1,454 |) |
| Net income (loss) | \$2,496 | \$(101 |) \$3,603 | \$1,325 | |
| Net income per common share: | | | | | |
| Basic | \$0.10 | \$— | \$0.15 | \$0.05 | |
| Diluted | \$0.10 | \$— | \$0.14 | \$0.05 | |
| Weighted average common shares: | | | | | |
| Basic | 24,938 | 25,274 | 24,525 | 25,545 | |
| Diluted | 25,710 | 25,274 | 25,085 | 25,965 | |

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

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DIGI INTERNATIONAL INC.
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
 (UNAUDITED)

| | Three months ended June 30, | | Nine months ended June 30, | | |
|---|-----------------------------|--------|----------------------------|-----------|---|
| | 2015 | 2014 | 2015 | 2014 | |
| | (in thousands) | | | | |
| Net income (loss) | \$2,496 | \$(101 |) \$3,603 | \$1,325 | |
| Other comprehensive income (loss), net of tax: | | | | | |
| Foreign currency translation adjustment | 1,571 | 384 | (4,158 |) 546 | |
| Change in net unrealized gain (loss) on investments | 4 | (2 |) (2 |) 62 | |
| Less income tax (provision) benefit | (1 |) 1 | 1 | (24 |) |
| Reclassification of realized loss on investments included in net income (1) | — | — | 1 | — | |
| Other comprehensive income (loss), net of tax | 1,574 | 383 | (4,158 |) 584 | |
| Comprehensive income (loss) | \$4,070 | \$282 | \$(555 |) \$1,909 | |

(1) Recorded in Other income (loss), net on our Condensed Consolidated Statement of Operations.

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

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CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

| | June 30, 2015 | September 30, 2014 |
|--|-----------------------------------|--------------------|
| | (in thousands, except share data) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$53,755 | \$47,490 |
| Marketable securities | 37,527 | 32,898 |
| Accounts receivable, net | 24,415 | 28,576 |
| Inventories | 34,690 | 31,247 |
| Deferred tax assets | 3,072 | 3,221 |
| Other | 2,912 | 4,249 |
| Total current assets | 156,371 | 147,681 |
| Marketable securities, long-term | 9,471 | 11,541 |
| Property, equipment and improvements, net | 14,628 | 13,231 |
| Identifiable intangible assets, net | 4,789 | 6,785 |
| Goodwill | 102,497 | 103,398 |
| Deferred tax assets | 5,708 | 7,383 |
| Other | 293 | 440 |
| Total assets | \$293,757 | \$290,459 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$7,048 | \$10,451 |
| Accrued compensation | 10,464 | 8,133 |
| Other | 3,372 | 3,170 |
| Total current liabilities | 20,884 | 21,754 |
| Income taxes payable | 1,401 | 2,724 |
| Deferred tax liabilities | 151 | 272 |
| Other noncurrent liabilities | 678 | 411 |
| Total liabilities | 23,114 | 25,161 |
| Contingencies (see Note 9) | | |
| 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; 31,499,053 and 30,703,895 shares issued | 315 | 307 |
| Additional paid-in capital | 226,102 | 218,689 |
| Retained earnings | 121,419 | 117,816 |
| Accumulated other comprehensive loss | (22,435) | (18,277) |
| Treasury stock, at cost, 6,513,712 and 6,313,937 shares | (54,758) | (53,237) |
| Total stockholders' equity | 270,643 | 265,298 |
| Total liabilities and stockholders' equity | \$293,757 | \$290,459 |

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

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

| | Nine months ended June 30, | |
|---|-------------------------------|------------|
| | 2015 | 2014 |
| | (in thousands) | |
| Operating activities: | | |
| Net income | \$3,603 | \$1,325 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation of property, equipment and improvements | 2,170 | 2,694 |
| Amortization of identifiable intangible assets | 2,286 | 2,787 |
| Stock-based compensation | 3,262 | 3,160 |
| Excess tax benefits from stock-based compensation | — | (44) |
| Deferred income tax provision (benefit) | 1,729 | (2,033) |
| Gain on insurance settlement related to property and equipment | (1,375) |) — |
| Bad debt/product return provision (recovery) | 198 | (196) |
| Inventory obsolescence | 842 | 610 |
| Restructuring charges, net | 509 | 81 |
| Other | (81) |) (24) |
| Changes in operating assets and liabilities | (4,147) |) (5,815) |
| Net cash provided by operating activities | 8,996 | 2,545 |
| Investing activities: | | |
| Purchase of marketable securities | (31,054) |) (15,574) |
| Proceeds from maturities of marketable securities | 28,494 | 35,364 |
| Proceeds from insurance settlement related to property and equipment | 1,400 | — |
| Proceeds from sale of property and equipment | 45 | — |
| Purchase of property, equipment, improvements and certain other intangible assets | (3,888) |) (2,719) |
| Net cash (used in) provided by investing activities | (5,003) |) 17,071 |
| Financing activities: | | |
| Excess tax benefits from stock-based compensation | — | 44 |
| Proceeds from stock option plan transactions | 6,332 | 3,336 |
| Proceeds from employee stock purchase plan transactions | 708 | 770 |
| Purchases of common stock | (2,339) |) (9,651) |
| Net cash provided by (used in) financing activities | 4,701 | (5,501) |
| Effect of exchange rate changes on cash and cash equivalents | (2,429) |) 482 |
| Net increase in cash and cash equivalents | 6,265 | 14,597 |
| Cash and cash equivalents, beginning of period | 47,490 | 41,320 |
| Cash and cash equivalents, end of period | \$53,755 | \$55,917 |
| The accompanying notes are an integral part of the condensed consolidated financial statements. | | |

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DIGI INTERNATIONAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. BASIS OF PRESENTATION OF UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The interim unaudited condensed consolidated financial statements included in this Form 10-Q have been prepared by Digi International Inc. (the “Company,” “Digi,” “we,” “our,” or “us”) pursuant to the rules and regulations of the United States Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures, normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”), have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto, including (but not limited to) the summary of significant accounting policies, presented in our Annual Report on Form 10-K for the year ended September 30, 2014 as filed with the SEC (“2014 Financial Statements”).

The condensed consolidated financial statements presented herein reflect, in the opinion of management, all adjustments which consist only of normal, recurring adjustments necessary for a fair statement of the condensed consolidated balance sheets and condensed consolidated statements of operations, comprehensive income (loss) and cash flows for the periods presented. The condensed consolidated results of operations for any interim period are not necessarily indicative of results for the full year. The year-end condensed consolidated balance sheet data were derived from our 2014 Financial Statements, but do not include all disclosures required by U.S. GAAP.

Recently Issued Accounting Pronouncements

In April 2015, the Financial Accounting Standards Board (“FASB”) issued ASU 2015-05, “Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40) - Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement. The new standard provides guidance to customers about whether a cloud computing arrangement includes a software license. If the arrangement does include a software license, the software license element of the arrangement should be accounted for in the same manner as the acquisition of other software licenses. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, with early adoption permitted. We expect to adopt this guidance beginning with our fiscal quarter ending December 31, 2016. We do not expect this guidance to have a material impact on our consolidated financial statements.

In May 2014, FASB issued ASU 2014-09, “Revenue from Contracts with Customers.” This guidance provides a five-step analysis in determining when and how revenue is recognized so that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods and services. It also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In July 2015, the FASB approved a one-year deferral of the effective date of ASU 2014-09, Revenue from Contracts with Customers. We can elect to adopt the provisions of ASU 2014-09 for annual periods beginning after December 15, 2017, including interim periods within that reporting period. The FASB also agreed to allow entities to choose to adopt the standard as of the original effective date. We are assessing the adoption date and potential impact of adopting this ASU on our consolidated financial statements and related disclosures.

2. EARNINGS PER SHARE

Basic net income per common share is calculated based on the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares result from dilutive common stock options and restricted stock units. Diluted net loss per common share is computed by dividing net loss by the weighted average number of common shares. All

potentially dilutive common equivalent shares are excluded from the calculations of net loss per diluted share due to their anti-dilutive effect. As a result, no common equivalent shares were included in the calculation of net loss per diluted share for the three month period ended June 30, 2014.

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2. EARNINGS PER 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):

| | Three months ended June 30, | | Nine months ended June 30, | |
|---|-----------------------------|---------|----------------------------|---------|
| | 2015 | 2014 | 2015 | 2014 |
| Numerator: | | | | |
| Net income (loss) | \$2,496 | \$(101) | \$3,603 | \$1,325 |
| Denominator: | | | | |
| Denominator for basic net income per common share — weighted average shares outstanding | 24,938 | 25,274 | 24,525 | 25,545 |
| Effect of dilutive securities: | | | | |
| Stock options and restricted stock units | 772 | — | 560 | 420 |
| Denominator for diluted net income per common share — adjusted weighted average shares | 25,710 | 25,274 | 25,085 | 25,965 |
| Net income per common share, basic | \$0.10 | \$— | \$0.15 | \$0.05 |
| Net income per common share, diluted | \$0.10 | \$— | \$0.14 | \$0.05 |

For the three months ended June 30, 2015 and 2014, there were 2,416,518 and 4,979,372 potentially dilutive shares, respectively, and for the nine months ended June 30, 2015 and 2014, there were 3,451,827 and 3,399,013 potentially dilutive shares, respectively, related to stock options to purchase common shares that were not included in the above computation of diluted earnings per common share. This is because the options' exercise prices were greater than the average market price of our common shares.

3. SELECTED BALANCE SHEET DATA

(in thousands)

| | June 30, 2015 | September 30, 2014 |
|--------------------------------------|---------------|--------------------|
| Accounts receivable, net: | | |
| Accounts receivable | \$24,812 | \$28,943 |
| Less allowance for doubtful accounts | 397 | 367 |
| Accounts receivable, net | \$24,415 | \$28,576 |
| Inventories: | | |
| Raw materials | \$28,043 | \$26,402 |
| Work in process | 615 | 315 |
| Finished goods | 6,032 | 4,530 |
| Inventories | \$34,690 | \$31,247 |

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

4. MARKETABLE SECURITIES

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

In order to estimate the fair value for each security in our investment portfolio, we obtain quoted market prices and trading activity for each security where available. We obtain relevant information from our investment advisor and, if warranted, also may review the financial solvency of certain security issuers. As of June 30, 2015, 25 of our 63 securities that we held were trading below our amortized cost basis. We determined each decline in value to be temporary based upon the above described

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4. MARKETABLE SECURITIES (CONTINUED)

factors. We expect to realize the fair value of these securities, plus accrued interest, either at the time of maturity or when the security is sold. All of our current holdings are classified as available-for-sale marketable securities and are recorded at fair value on our consolidated balance sheet with the unrealized gains and losses recorded in accumulated other comprehensive loss. All of our current marketable securities will mature in less than one year and our non-current marketable securities will mature in less than three years. During the three months ended June 30, 2015 and 2014, we received proceeds from our available-for-sale marketable securities of \$8.7 million and \$21.6 million, respectively. During the nine months ended June 30, 2015 and 2014, we received proceeds from our available-for-sale marketable securities of \$28.5 million and \$35.4 million, respectively.

At June 30, 2015 our marketable securities were (in thousands):

| | Amortized Cost (1) | Unrealized Gains | Unrealized Losses | Fair Value (1) |
|------------------------------------|-----------------------|---------------------|----------------------|-------------------|
| Current marketable securities: | | | | |
| Corporate bonds | \$28,065 | \$— | \$(31) |) \$28,034 |
| Commercial paper | 3,991 | — | (4) |) 3,987 |
| Certificates of deposit | 5,502 | 4 | — | 5,506 |
| Current marketable securities | 37,558 | 4 | (35) |) 37,527 |
| Non-current marketable securities: | | | | |
| Corporate bonds | 3,723 | — | (14) |) 3,709 |
| Certificates of deposit | 4,504 | 13 | — | 4,517 |
| Government municipal bonds | 1,246 | — | (1) |) 1,245 |
| Non-current marketable securities | 9,473 | 13 | (15) |) 9,471 |
| Total marketable securities | \$47,031 | \$17 | \$(50) |) \$46,998 |

(1) Included in amortized cost and fair value is purchased and accrued interest of \$262.

At September 30, 2014 our marketable securities were (in thousands):

| | Amortized Cost (1) | Unrealized Gains | Unrealized Losses | Fair Value (1) |
|------------------------------------|-----------------------|---------------------|----------------------|-------------------|
| Current marketable securities: | | | | |
| Corporate bonds | \$24,668 | \$1 | \$(22) |) \$24,647 |
| Commercial paper | 3,998 | — | (1) |) 3,997 |
| Certificates of deposit | 4,252 | 2 | — | 4,254 |
| Current marketable securities | 32,918 | 3 | (23) |) 32,898 |
| Non-current marketable securities: | | | | |
| Corporate bonds | 2,051 | — | (4) |) 2,047 |
| Certificates of deposit | 9,502 | 14 | (22) |) 9,494 |
| Non-current marketable securities | 11,553 | 14 | (26) |) 11,541 |
| Total marketable securities | \$44,471 | \$17 | \$(49) |) \$44,439 |

(1) Included in amortized cost and fair value is purchased and accrued interest of \$213.

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4. MARKETABLE SECURITIES (CONTINUED)

The following tables show the fair values and gross unrealized losses of our available-for-sale marketable securities that have been in a continuous unrealized loss position deemed to be temporary, aggregated by investment category (in thousands):

| | June 30, 2015 | | | |
|----------------------------|---------------------|-------------------|---------------------|-------------------|
| | Less than 12 Months | | More than 12 Months | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate bonds | \$26,499 | \$(44) | \$5,002 | \$(1) |
| Commercial paper | 1,991 | (4) | — | — |
| Government municipal bonds | 1,230 | (1) | — | — |
| Total | \$29,720 | \$(49) | \$5,002 | \$(1) |
| | September 30, 2014 | | | |
| | Less than 12 Months | | More than 12 Months | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate bonds | \$23,475 | \$(26) | \$— | \$— |
| Commercial paper | 3,998 | (1) | — | — |
| Certificates of deposit | 2,980 | (20) | 748 | (2) |
| Total | \$30,453 | \$(47) | \$748 | \$(2) |

5. FAIR VALUE MEASUREMENTS

Fair value is defined as the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. This standard also establishes a hierarchy for inputs used in measuring fair value. This standard maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability based on market data obtained from independent sources. Unobservable inputs are inputs that reflect our assumptions about the factors market participants would use in valuing the asset or liability based upon the best information available in the circumstances.

The categorization of financial assets and liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The hierarchy is broken down into three levels. Level 1 inputs are quoted prices in active markets for identical assets or liabilities. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable for the asset or liability and their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 may also include certain investment securities for which there is limited market activity or a decrease in the observability of market pricing for the investments, such that the determination of fair value requires significant judgment or estimation.

Fair value is applied to financial assets such as our marketable securities, which are classified and accounted for as available-for-sale. These items are stated at fair value at each reporting period using the above guidance.

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5. FAIR VALUE MEASUREMENTS (CONTINUED)

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

| | Total carrying value at June 30, 2015 | Fair Value Measurements Using Inputs Considered as | | |
|--|---|---|----------|---------|
| | | Level 1 | Level 2 | Level 3 |
| Cash equivalents: | | | | |
| Money market | \$19,199 | \$19,199 | \$— | \$— |
| Available-for-sale marketable securities: | | | | |
| Corporate bonds | 31,743 | — | 31,743 | — |
| Commercial paper | 3,987 | — | 3,987 | — |
| Certificates of deposit | 10,023 | — | 10,023 | — |
| Government municipal bonds | 1,245 | — | 1,245 | — |
| Total cash equivalents and marketable securities measured at fair value | \$66,197 | \$19,199 | \$46,998 | \$— |

| | Total carrying value at September 30, 2014 | Fair Value Measurements Using Inputs Considered as | | |
|--|--|---|----------|---------|
| | | Level 1 | Level 2 | Level 3 |
| Cash equivalents: | | | | |
| Money market | \$19,630 | \$19,630 | \$— | \$— |
| Available-for-sale marketable securities: | | | | |
| Corporate bonds | 26,694 | — | 26,694 | — |
| Commercial paper | 3,997 | — | 3,997 | — |
| Certificates of deposit | 13,748 | — | 13,748 | — |
| Total cash equivalents and marketable securities measured at fair value | \$64,069 | \$19,630 | \$44,439 | \$— |

Our money market funds, which have been determined to be cash equivalents, are measured at fair value using quoted market prices in active markets for identical assets and are therefore classified as Level 1 assets. We value our Level 2 assets using inputs that are based on market indices of similar assets within an active market. There were no transfers into or out of our Level 2 financial assets during the nine months ended June 30, 2015.

We did not carry, purchase or sell any Level 3 financial assets during the nine months ended June 30, 2015.

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

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6. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS, NET

Amortizable identifiable intangible assets were (in thousands):

| | June 30, 2015 | | | September 30, 2014 | | |
|-------------------------------|-----------------------|---------------|---------|-----------------------|---------------|---------|
| | Gross carrying amount | Accum. amort. | Net | Gross carrying amount | Accum. amort. | Net |
| Purchased and core technology | \$45,659 | \$(45,510) | \$ 149 | \$45,952 | \$(45,162) | \$ 790 |
| License agreements | — | — | — | 2,440 | (2,440) | — |
| Patents and trademarks | 11,993 | (10,560) | 1,433 | 11,667 | (9,799) | 1,868 |
| Customer relationships | 18,609 | (15,915) | 2,694 | 18,894 | (15,445) | 3,449 |
| Non-compete agreements | 1,100 | (587) | 513 | 1,100 | (422) | 678 |
| Order backlog | — | — | — | 360 | (360) | — |
| Total | \$77,361 | \$(72,572) | \$4,789 | \$80,413 | \$(73,628) | \$6,785 |

Amortization expense was \$0.7 million and \$0.9 million for the three month periods ended June 30, 2015 and 2014, respectively. Amortization expense was \$2.3 million and \$2.8 million for the nine month periods ended June 30, 2015 and 2014, respectively. Amortization expense is recorded on our consolidated statements of operations within cost of sales and in general and administrative expense.

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2015 and the five succeeding fiscal years is (in thousands):

| | |
|-------------------|-------|
| 2015 three months | \$625 |
| 2016 | 1,926 |
| 2017 | 896 |
| 2018 | 487 |
| 2019 | 451 |
| 2020 | 168 |

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

| | Nine months ended | |
|---|-------------------|-----------|
| | June 30, 2015 | 2014 |
| Beginning balance, October 1 | \$103,398 | \$103,569 |
| Foreign currency translation adjustment | (901) | 760 |
| Ending balance, June 30 | \$102,497 | \$104,329 |

Goodwill is tested for impairment on an annual basis as of June 30, or more frequently if events or circumstances occur which could indicate impairment. The calculation of goodwill impairment requires us to make assumptions about the fair value of our one reporting unit, which historically has been approximated by using our market capitalization plus a control premium. Control premium assumptions require judgment and actual results may differ from assumed or estimated amounts.

Our test for potential goodwill impairment is a two-step approach. We estimate the fair value for our one reporting unit by comparing its fair value (market capitalization plus control premium) to our carrying value. If the carrying value of the reporting unit exceeds its estimated fair value, the second step of the goodwill impairment analysis requires us to measure the amount of the impairment loss. An impairment loss is calculated by comparing the implied fair value of the goodwill to its carrying amount. To calculate the implied fair value of goodwill, the fair value of the reporting unit's assets and liabilities, excluding goodwill, is estimated. The excess of the fair value of the reporting unit over the amount assigned to its assets and liabilities, excluding goodwill, is the implied fair value of the reporting unit's goodwill.

At June 30, 2015, our market capitalization was \$238.6 million compared to our carrying value of \$270.6 million. Our market capitalization plus our estimated control premium of 35% (discussed in the paragraphs below) resulted in a fair value in excess

Table of Contents**6. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS, NET (CONTINUED)**

of our carrying value by a margin of 19%. We concluded that no impairment was indicated and we were not required to complete the second step of the goodwill impairment analysis. No goodwill impairment charges were recorded. In June 2014, we performed a control premium study to determine the appropriate control premium to include in the calculation of fair value. We used a third party valuation firm to assist us in performing this control premium analysis. In order to estimate the range of control premiums appropriate for us, the following three methodologies were used: (1) analysis of individual transactions within our industry; (2) analysis of industry-wide data, and (3) analysis of global transaction data. Individual transactions in the Communication Equipment or Technology Hardware, Storage and Peripherals industries were used to find transactions of target companies that operated in similar markets and shared similar operating characteristics with us. Transaction screening criteria included selection of transactions with the following characteristics:

- At least 50 percent of a target company's equity sought by an acquirer,
- Target company considered operating (not in bankruptcy),
- Target company had publicly traded stock outstanding at the transaction date, and
- Transactions announced between June 30, 2009 and the valuation date.

In analyzing industry-wide data, transactions in the following three industries were identified that encompassed the products offered by us: Office Equipment and Computer Hardware, Communications, and Computer, Supplies and Services. Finally, control premiums were considered for both domestic and international transactions. The control premium analysis resulted in a range of control premium of 30 percent to 40 percent. We reviewed the data and concluded that a 35 percent control premium best represented the amount an investor would likely pay, over and above market capitalization, in order to obtain a controlling interest given the economic conditions at that time. Based on our industry knowledge, including recent industry merger and acquisition activity, we concluded that the control premium study that was performed a year ago is still an appropriate study to use for our June 30, 2015 goodwill impairment assessment.

If our stock price or control premium declines, the first step of our goodwill impairment analysis may fail. We have identified factors that could result in additional interim goodwill impairment testing. For example, we would perform the second step of the impairment testing if our stock price fell below certain thresholds for a significant period of time, or if our control premium significantly decreased. Events or circumstances may occur that could negatively impact our stock price, including changes in our anticipated revenues and profits and our ability to execute on our strategies. In addition, our control premium could decline due to changes in economic conditions in the technology industry or more generally in the financial markets. An impairment could have a material effect on our consolidated balance sheet and results of operations. We have had no goodwill impairment losses since the adoption of Accounting Standards Codification (ASC) 350, Intangibles-Goodwill and Others, in fiscal 2003.

7. INCOME TAXES

Income tax provision was \$0.8 million for the nine month period ended June 30, 2015. Net tax benefits specific to the nine months ended June 30, 2015 were \$0.9 million resulting from the reinstatement of the research and development tax credit for calendar year 2014 and reversal of tax reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions. These discrete tax benefits were partially offset by a discrete tax expense for the adjustment of state rate on net deferred tax assets. For the nine month period ended June 30, 2015, our effective tax rate before items specific to the period was more than the U.S. statutory rate due primarily to mix of income between taxing jurisdictions, certain of which have higher statutory tax rates than the U.S., an increase in permanent tax items and an increase in certain reserves for unrecognized tax benefits.

Income tax benefit was \$1.5 million for the nine month period ended June 30, 2014. Net tax benefits specific to the period of \$1.4 million related to the re-measurement and reversal of certain income tax reserves as a result of the conclusion in March 2014 of a federal income tax audit for fiscal 2012, a reversal of reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions and a valuation allowance reversal associated with the reassessment of state research and development tax credits. For the nine month period ended June 30, 2014, our effective tax rate before items specific to the period was more than the statutory rate primarily due to an adjustment

for certain foreign income taxed at the U.S. rate and lower than expected benefits associated with certain state credits.

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Table of Contents**7. INCOME TAXES (CONTINUED)**

Our effective tax rate will vary based on a variety of factors, including overall profitability, the geographical mix of income before taxes and related statutory tax rate in each jurisdiction, and tax items specific to the period, such as settlements of audits. We expect that we may record other benefits or expenses in the future that are specific to a particular quarter such as expiration of statutes of limitation, the completion of tax audits, or legislation that is enacted for both U.S. and foreign jurisdictions.

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

| | | |
|--|---------|---|
| Unrecognized tax benefits as of September 30, 2014 | \$2,301 | |
| Increases related to: | | |
| Prior year income tax positions | 110 | |
| Decreases related to: | | |
| Prior year income tax positions | (255 |) |
| Settlements | (74 |) |
| Expiration of statute of limitations | (543 |) |
| Unrecognized tax benefits as of June 30, 2015 | \$1,539 | |

The total amount of unrecognized tax benefits that, if recognized, would affect our effective tax rate is \$1.5 million, after considering the impact of interest and deferred benefit items. We expect the total amounts of unrecognized tax benefits will decrease by approximately \$0.2 million over the next 12 months.

Of the \$1.5 million of unrecognized tax benefits, \$1.1 million is included in non-current income taxes payable and \$0.4 million is included with non-current deferred tax assets on the condensed consolidated balance sheet at June 30, 2015.

We recognize interest and penalties related to income tax matters in income tax expense. During both the nine month periods ended June 30, 2015 and 2014, there were insignificant amounts of interest and penalties related to income tax matters in income tax expense. Accrued interest and penalties related to unrecognized tax benefits was \$0.3 million and \$0.4 million at June 30, 2015 and September 30, 2014, respectively. Our non-current income taxes payable on our condensed consolidated balance sheet includes accrued interest and penalties in addition to the unrecognized tax benefits of \$1.1 million at June 30, 2015.

At June 30, 2015, we had approximately \$28.8 million of accumulated undistributed foreign earnings, for which we have not accrued additional U.S. tax. Our policy is to reinvest earnings of our foreign subsidiaries indefinitely to fund current operations and provide for future international expansion opportunities, and only to repatriate earnings to the extent that U.S. taxes have already been recorded. Although we have no current need to do so, if we change our assertion that we do not intend to repatriate additional undistributed foreign earnings for cash requirements in the United States, we would have to accrue applicable taxes. The amount of any taxes and the application of any tax credits would be determined based on the income tax laws at the time of such repatriation. Under current tax laws, we estimate the unrecognized deferred tax liability to be in the range of \$0.9 million to \$1.9 million.

We operate in multiple tax jurisdictions, including the U.S. and other jurisdictions 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 balance sheet and results of operations. We are no longer subject to income tax examination for tax years prior to fiscal 2013 for U.S. federal income tax authorities, and prior to fiscal 2009 for non-U.S. income tax authorities. For state taxing authorities, most notably in California and Texas, we are no longer subject to income tax examination for tax years generally before fiscal 2010, and for Minnesota for tax years prior to fiscal 2013.

8. PRODUCT WARRANTY OBLIGATION

In general, we warrant our products to be free from defects in material and workmanship under normal use and service. The warranty periods generally range from one to five years. We typically have the option to either repair or replace products we deem defective with regard to material or workmanship. Estimated warranty costs are accrued in

the period that the related revenue is recognized based upon an estimated average per unit repair or replacement cost applied to the estimated number of units under warranty. These estimates are based upon historical warranty incidents and are evaluated on an ongoing basis to ensure the adequacy of the warranty accrual.

Table of Contents**8. PRODUCT WARRANTY OBLIGATION (CONTINUED)**

The following table summarizes the activity associated with the product warranty accrual (in thousands) and is included on our Condensed Consolidated Balance Sheets within current liabilities:

| Period | Balance at April 1 | Warranties issued | Settlements made | Balance at June 30 |
|----------------------------------|-----------------------|----------------------|---------------------|-----------------------|
| Three months ended June 30, 2015 | \$923 | \$276 | \$(192) |) \$1,007 |
| Three months ended June 30, 2014 | \$972 | \$105 | \$(177) |) \$900 |

| Period | Balance at October 1 | Warranties issued | Settlements made | Balance at June 30 |
|---------------------------------|-------------------------|----------------------|---------------------|-----------------------|
| Nine months ended June 30, 2015 | \$862 | \$773 | \$(628) |) \$1,007 |
| Nine months ended June 30, 2014 | \$1,063 | \$427 | \$(590) |) \$900 |

We are not responsible for, and do not warrant that, custom software versions, created by original equipment manufacturer (OEM) customers based upon our software source code, will function in a particular way, will conform to any specifications or are fit for any particular purpose. Further, we do not indemnify these customers from any third-party liability as it relates to or arises from any customization or modifications made by the OEM customer.

9. CONTINGENCIES

In the normal course of business, we are subject to various claims and litigation. There can be no assurance that any claims by third parties, if proven to have merit, will not materially adversely affect our business, liquidity or financial condition.

10. STOCK-BASED COMPENSATION

Stock-based awards were granted under the 2014 Omnibus Incentive Plan (the "2014 Plan") during the nine months ended June 30, 2015. During the nine months ended June 30, 2014, stock-based awards were granted under the 2013 Omnibus Incentive Plan (which expired during the second quarter of fiscal 2014) and the 2014 Plan. Upon stockholder approval of the 2014 Plan, we ceased granting awards under any prior plan. The authority to grant options under the 2014 Plan and set other terms and conditions rests with the Compensation Committee of the Board of Directors.

The 2014 Plan authorizes the issuance of up to 2,250,000 common shares in connection with awards of stock options, stock appreciation rights, restricted stock, restricted stock units, performance-based full value awards or other stock-based awards. Eligible participants include our employees, our affiliates, non-employee directors of our Company and any consultant or advisor who is a natural person and provides services to us or our affiliates. Options that have been granted under the 2014 Plan typically vest over a four year service period and will expire if unexercised after eight years from the date of grant. Restricted stock awards (RSU's) that have been granted to Directors typically vest in one year. RSU's that have been granted to executives and employees typically vest in November over a four-year period. Awards may be granted under the 2014 Plan until January 27, 2024. Options under the 2014 Plan can be granted as either incentive stock options (ISOs) or non-statutory stock options (NSOs). The exercise price of options and the grant date price of restricted stock 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. Upon exercise, we issue new shares of stock. Our equity plans and corresponding forms of award agreements generally have provisions allowing employees to elect to satisfy tax withholding obligations through the delivery of shares, having us retain a portion of shares issuable under the award or paying cash to us for the withholding. As of June 30, 2015, there were approximately 1,317,996 shares available for future grants under the 2014 Plan.

Cash received from the exercise of stock options was \$6.3 million during the nine months ended June 30, 2015 and \$3.3 million during the nine months ended June 30, 2014. There were no excess tax benefits from stock-based compensation for the nine months ended June 30, 2015. The excess tax benefits from stock-based compensation were minimal during the nine months ended June 30, 2014.

We sponsor an Employee Stock Purchase Plan (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. Employee contributions to the Purchase Plan were \$0.7 million during the nine

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10. STOCK-BASED COMPENSATION (CONTINUED)

months ended June 30, 2015 and \$0.8 million during the nine months ended June 30, 2014, respectively. Pursuant to the Purchase Plan, 97,383 and 92,321 common shares were issued to employees during the nine months ended June 30, 2015 and 2014, respectively. Shares are issued under the Purchase Plan from treasury stock. As of June 30, 2015, 643,995 common shares were available for future issuances under the Purchase Plan.

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

| | Three months ended June 30, | | Nine months ended June 30, | |
|--|-----------------------------|-------|----------------------------|---------|
| | 2015 | 2014 | 2015 | 2014 |
| Cost of sales | \$88 | \$92 | \$277 | \$242 |
| Sales and marketing | 283 | 285 | 932 | 853 |
| Research and development | 193 | 176 | 581 | 559 |
| General and administrative | 476 | 537 | 1,472 | 1,506 |
| Stock-based compensation before income taxes | 1,040 | 1,090 | 3,262 | 3,160 |
| Income tax benefit | (366) | (378) | (1,141) | (1,081) |
| Stock-based compensation after income taxes | \$674 | \$712 | \$2,121 | \$2,079 |

Stock-based compensation cost capitalized as part of inventory was immaterial as of June 30, 2015 and September 30, 2014.

The following table summarizes our stock option activity (in thousands, except per common share amounts):

| | Options Outstanding | Weighted Average Exercised Price | Weighted Average Contractual Term (in years) | Aggregate Intrinsic Value (1) |
|-------------------------------|---------------------|----------------------------------|--|-------------------------------|
| Balance at September 30, 2014 | 6,029 | \$10.61 | | |
| Granted | 810 | 8.12 | | |
| Exercised | (714) | 8.87 | | |
| Forfeited / Canceled | (1,230) | 11.59 | | |
| Balance at June 30, 2015 | 4,895 | \$10.21 | 5.2 | \$2,209 |
| Exercisable at June 30, 2015 | 3,498 | \$10.68 | 4.4 | \$984 |

(1) The aggregate intrinsic value represents the total pre-tax intrinsic value, based on our closing stock price of \$9.55 as of June 30, 2015, which would have been received by the option holders had all option holders exercised their options as of that date. 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 the nine months ended June 30, 2015 was \$0.8 million and during the nine months ended June 30, 2014 was \$0.5 million.

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:

| | Nine months ended June 30, | |
|---|----------------------------|---------------|
| | 2015 | 2014 |
| Weighted average per option grant date fair value | \$2.98 | \$4.38 |
| Assumptions used for option grants: | | |
| Risk free interest rate | 1.57% - 1.85% | 1.76% - 2.02% |
| Expected term | 6.00 years | 6.00 years |
| Expected volatility | 32% - 36% | 39% - 40% |
| Weighted average volatility | 35% | 40% |
| Expected dividend yield | 0 | 0 |

Table of Contents**10. STOCK-BASED COMPENSATION (CONTINUED)**

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.

We use historical data to estimate pre-vesting forfeiture rates. The pre-vesting forfeiture rate used during the nine months ended June 30, 2015 was 6.0%. As of June 30, 2015 the total unrecognized compensation cost related to non-vested stock options, net of expected forfeitures, was \$4.2 million and the related weighted average period over which it is expected to be recognized is approximately 2.9 years.

A summary of our non-vested restricted stock units as of June 30, 2015 and changes during the nine months then ended is presented below (in thousands, except per common share amounts):

| | Number of Awards | Weighted Average Grant Date Fair Value |
|---------------------------------|---------------------|--|
| Nonvested at September 30, 2014 | 171 | \$9.35 |
| Granted | 490 | \$8.22 |
| Vested | (81 |) \$9.60 |
| Canceled | (30 |) \$7.90 |
| Nonvested at June 30, 2015 | 550 | \$8.39 |

As of June 30, 2015, the total unrecognized compensation cost related to non-vested restricted stock units was \$3.5 million and the related weighted average period over which it is expected to be recognized is approximately 1.7 years.

11. COMMON STOCK REPURCHASE

On October 28, 2014, our Board of Directors authorized a new program to repurchase up to \$15.0 million of our common stock primarily to return capital to shareholders and to support our employee stock purchase program. This new authorization began on November 1, 2014 and expires on October 31, 2015. Shares repurchased under the program may be made through the open market and privately negotiated transactions from time to time and in amounts that management deems appropriate. The amount and timing of share repurchases will depend upon market conditions and other corporate considerations. We did not repurchase shares under this program during the first nine months of fiscal 2015.

Our prior share repurchase authorization program expired on October 31, 2014. During the month of October 2014, we repurchased 287,787 shares under this program for \$2.3 million.

In addition to the shares repurchased under the prior Board authorized repurchase program, during the nine months ended June 30, 2015, our employees forfeited 9,371 shares in order to satisfy \$0.1 million of withholding tax obligations related to stock-based compensation, pursuant to terms of awards under our board and shareholder-approved compensation plans.

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12. RESTRUCTURING

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

| | 2015 | 2014 | 2013 | |
|-------------------------------|---------------|---------------|---------------|--------|
| | Restructuring | Restructuring | Restructuring | |
| | Employee | Employee | Employee | |
| | Termination | Termination | Termination | Total |
| | Costs | Costs | Costs | |
| Balance at September 30, 2013 | \$— | \$— | \$350 | \$350 |
| Restructuring charge | — | 152 | — | 152 |
| Payments | — | (152 |) (279 |) (431 |
| Reversals | — | — | (71 |) (71 |
| Balance at September 30, 2014 | — | — | — | — |
| Restructuring charge | 518 | — | — | 518 |
| Payments | (497 |) — | — | (497 |
| Reversals | (9 |) — | — | (9 |
| Balance at June 30, 2015 | \$12 | \$— | \$— | \$12 |

Fiscal 2015 Restructuring

On February 20, 2015, we announced a restructuring plan related to our Etherios operations in order to refocus the business on CRM and service cloud implementations. We recorded a restructuring charge of \$0.3 million related to severance during the second quarter of fiscal 2015. We scaled the business to current and expected revenue levels resulting in an elimination of approximately 21 positions. The payments associated with these charges are expected to be completed by the end of fiscal 2015.

On January 22, 2015, we announced the closure of our India location. The March closure resulted in the elimination of approximately 38 employees from engineering, sales and administration. We recorded a restructuring charge of \$0.2 million related to severance during the second quarter of fiscal 2015. The payments associated with this charge were completed during the third quarter of fiscal 2015.

Fiscal 2014 Restructuring

On October 31, 2013, we announced our intention to restructure certain of our operations in India. The restructuring was primarily associated with cost reduction initiatives resulting in the elimination of approximately 40 engineering and sales positions in our work force. We recorded a restructuring charge of \$0.2 million related to severance during the first quarter of fiscal 2014. The majority of this severance was paid during the first quarter of fiscal 2014.

Fiscal 2013 Restructuring

On September 27, 2013, we announced our intention to restructure certain of our operations in the U.S. The restructuring was primarily associated with cost reduction initiatives and resulted in the elimination of 15 positions in our work force. We recorded a restructuring charge of \$0.4 million for severance during the fourth quarter of fiscal 2013. The payments associated with these charges and all the actions associated with the restructuring were completed during the first quarter of fiscal 2014.

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

Our management’s discussion and analysis should be read in conjunction with our Annual Report on Form 10-K and 10-K/A for the fiscal year ended September 30, 2014, as well as our subsequent reports on Forms 10-Q and 8-K.

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

This Form 10-Q contains certain statements that are “forward-looking statements” as that term is defined under the Private Securities Litigation Reform Act of 1995, and within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended.

Forward-Looking Statements

The words “anticipate,” “assume,” “believe,” “continue,” “estimate,” “expect,” “intend,” “may,” “plan,” “project,” “should,” or “will” and negative thereof or other variations thereon or similar terminology, which are predictions of or indicate future events and trends and which do not relate to historical matters, identify forward-looking statements. Among other items, these statements relate to expectations of the business environment in which we operate, projections of future performance, perceived marketplace opportunities and statements regarding our mission and vision. Such statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, including risks related to the highly competitive market in which our company operates, rapid changes in technologies that may displace products sold by us, declining prices of networking products, our reliance on distributors and other third parties to sell our products, delays in product development efforts, uncertainty in user acceptance of our products, the ability to integrate our products and services with those of other parties in a commercially accepted manner, potential liabilities that can arise if any of our products have design or manufacturing defects, our ability to defend or settle satisfactorily any litigation, uncertainty in global economic conditions and economic conditions within particular regions of the world which could negatively affect product demand and the financial solvency of customers and suppliers, the impact of natural disasters and other events beyond our control that could negatively impact our supply chain and customers, potential unintended consequences associated with restructuring or other similar business initiatives that may impact our operations and our ability to retain important employees, the ability to achieve the anticipated benefits and synergies associated with acquisitions, and changes in our level of revenue or profitability, which can fluctuate for many reasons beyond our control. These and other risks, uncertainties and assumptions identified from time to time in our filings with the United States Securities and Exchange Commission, including without limitation, our annual report on Form 10-K for the year ended September 30, 2014, and subsequent quarterly reports on Form 10-Q and other filings, could cause the company’s future results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. Many of such factors are beyond our ability to control or predict. These forward-looking statements speak only as of the date for which they are made. We disclaim any intent or obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

CRITICAL ACCOUNTING POLICIES 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 our condensed consolidated 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.

A description of our critical accounting policies and estimates was provided in the Management’s Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the year ended September 30, 2014. There have been no material changes to our critical accounting policies as disclosed in that report.

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

OVERVIEW

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

Total revenue was \$54.5 million for the third quarter of fiscal 2015 compared to \$47.9 million for the third quarter of fiscal 2014, an increase of \$6.6 million or 13.9%. This increase was driven by higher revenue performance due primarily to increased volume in our growth product category.

Operating income was \$2.8 million, or 5.2% of revenue, in the third quarter of fiscal 2015 compared to an operating loss of \$0.3 million, or 0.5% of revenue, in the year ago comparable quarter. The \$3.1 million increase resulted almost entirely from an increase in gross profit.

We received an additional \$0.4 million of property and casualty insurance proceeds in the third quarter of fiscal 2015 related to the replacement of our capital equipment destroyed in the fire at our subcontract manufacturer's location.

These property and casualty insurance proceeds were recorded in Other income (loss), net.

Net income was \$2.5 million in the third quarter of fiscal 2015, or \$0.10 per diluted share, compared to a net loss of \$0.1 million, or \$0.00 per diluted share, in the third quarter of fiscal 2014. Net income in the third quarter of fiscal 2015 included property and casualty insurance proceeds of \$0.3 million, net of tax, or \$0.01 per diluted share, and tax items specific to the period resulting in a net benefit of \$0.4 million or \$0.02 per diluted share.

CONSOLIDATED RESULTS OF OPERATIONS

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

| | Three months ended June 30, | | | % incr. Nine months ended June 30, | | | % incr. | | | |
|--------------------------|-----------------------------|--------|----------|------------------------------------|---------|-----------|---------|-----------|--------|---------|
| | 2015 | | 2014 | (decr.) 2015 | | 2014 | (decr.) | | | |
| Revenue: | | | | | | | | | | |
| Hardware product | \$50,001 | 91.7 % | \$43,303 | 90.4 % | 15.5 | \$143,042 | 91.5 % | \$125,852 | 89.2 % | 13.7 % |
| Service | 4,537 | 8.3 | 4,582 | 9.6 | (1.0) | 13,370 | 8.5 | 15,237 | 10.8 | (12.3) |
| Total revenue | 54,538 | 100.0 | 47,885 | 100.0 | 13.9 | 156,412 | 100.0 | 141,089 | 100.0 | 10.9 |
| Cost of sales: | | | | | | | | | | |
| Cost of hardware product | 25,729 | 47.2 | 21,587 | 45.1 | 19.2 | 74,339 | 47.5 | 61,862 | 43.8 | 20.2 |
| Cost of service | 3,460 | 6.3 | 4,149 | 8.6 | (16.6) | 10,724 | 7.0 | 12,390 | 8.8 | (13.4) |
| Total cost of sales | 29,189 | 53.5 | 25,736 | 53.7 | 13.4 | 85,063 | 54.5 | 74,252 | 52.6 | 14.6 |
| Gross profit | 25,349 | 46.5 | 22,149 | 46.3 | 14.4 | 71,349 | 45.6 | 66,837 | 47.4 | 6.8 |
| Operating expenses | 22,519 | 41.3 | 22,429 | 46.8 | 0.4 | 69,197 | 44.2 | 67,138 | 47.6 | 3.1 |
| | 2,830 | 5.2 | (280) | (0.5) | NM | 2,152 | 1.4 | (301) | (0.2) | NM |

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| | | | | | | | | | | |
|-----------------------------------|---------|-------|----------|--------|-----|---------|-------|----------|--------|---------|
| Operating income (loss) | | | | | | | | | | |
| Other income (loss), net | 461 | 0.8 | (34) | (0.1) | NM | 2,265 | 1.4 | 172 | 0.1 | NM |
| Income (loss) before income taxes | 3,291 | 6.0 | (314) | (0.6) | NM | 4,417 | 2.8 | (129) | (0.1) | NM |
| Income tax provision (benefit) | 795 | 1.4 | (213) | (0.4) | NM | 814 | 0.5 | (1,454) | (1.0) | NM |
| Net income (loss) | \$2,496 | 4.6 % | \$(101) | (0.2) | %NM | \$3,603 | 2.3 % | \$1,325 | 0.9 % | 171.9 % |

* NM means not meaningful

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

REVENUE

Overview

Total revenue was \$54.5 million for the third quarter of fiscal 2015 compared to \$47.9 million for the third quarter of fiscal 2014, an increase of \$6.6 million or 13.9%. Total revenue was \$156.4 million for the nine months ended June 30, 2015 compared to \$141.1 million for the nine months ended June 30, 2014, an increase of \$15.3 million or 10.9%. The increase in revenue for both the three and nine month periods ended June 30, 2015 as compared to the comparable periods in the prior fiscal year was driven by higher revenue performance primarily due to increased volume. No significant changes were made to our pricing strategy that impacted revenue during the three and nine month periods ended June 30, 2015 as compared to the same periods in the prior fiscal year. As foreign currency rates fluctuate, we may from time to time adjust the prices of our products and services.

Hardware Products

| (\$ in thousands) | Three months ended June 30, | | | % incr. (decr.) | Nine months ended June 30, | | | % incr. (decr.) | | |
|--------------------------|-----------------------------|---------|----------|--------------------|----------------------------|-----------|---------|--------------------|---------|--------|
| | 2015 | 2014 | | | 2015 | 2014 | | | | |
| Growth hardware products | \$27,590 | 55.2 % | \$21,751 | 50.2 % | 26.8 % | \$83,816 | 58.6 % | \$64,369 | 51.1 % | 30.2 % |
| Mature hardware products | 22,411 | 44.8 | 21,552 | 49.8 | 4.0 | 59,226 | 41.4 | 61,483 | 48.9 | (3.7) |
| Total product revenue | \$50,001 | 100.0 % | \$43,303 | 100.0 % | 15.5 % | \$143,042 | 100.0 % | \$125,852 | 100.0 % | 13.7 % |

Growth hardware product offerings include all wireless products as well as the ARM-based embedded module product line with both wired and wireless connectivity. Revenue from growth hardware products increased by \$5.8 million and \$19.4 million for the three and nine month periods ended June 30, 2015, respectively, compared to the same periods a year ago. This increase was primarily related to increased revenue from large sales to certain customers of our cellular routers and gateway products and our RF and embedded modules.

Mature hardware product offerings include generally all wired products, such as our serial servers, Rabbit-branded modules, chips and USB connected products. Revenue of our mature hardware products increased by \$0.9 million for the three month period ended June 30, 2015 compared to the same period a year ago. This increase was primarily due to an increase in revenue from serial servers, Rabbit-branded modules and chips, partially offset by a decrease in revenue from serial cards, USB connected products and satellite-related products. For the nine month period ended June 30, 2015 mature hardware products decreased by \$2.2 million compared to the same period a year ago. During that period, most products in this category decreased, partially offset by increases in revenue from serial servers and chips. We expect that revenue from our mature hardware products will continue to decrease in the future; however, we may experience occasional increases in certain mature product offerings due to specific customer purchases.

Services

Our service offerings include our wireless product design and development services, customer relationship management (CRM) consulting services, application development services, our platform-as-a-service (PAAS) recurring revenue generated from our device cloud, and post-contract customer support and fees associated with technical support and training. Revenue from our service offerings was \$4.6 million for both of the three month periods ended June 30, 2015 and 2014. Wireless design services and device cloud revenue decreased in the third quarter of fiscal 2015, mostly offset by an increase in our CRM consulting service revenue. Revenue from our service offerings was \$13.4 million in the first nine months of fiscal 2015, compared to \$15.2 million in the first nine months of fiscal 2014, a decrease of \$1.8 million or 12.3%. It is likely that revenue from our service offerings will fluctuate from quarter to quarter.

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

Revenue by Geographic Location

The following summarizes our revenue by geographic location of our customers:

| (\$ in thousands) | Three months ended | | \$ incr. | % incr. | Nine months ended | | \$ incr. | % incr. |
|--|--------------------|----------|----------|---------|-------------------|-----------|----------|---------|
| | June 30, | June 30, | | | June 30, | June 30, | | |
| | 2015 | 2014 | (decr.) | (decr.) | 2015 | 2014 | (decr.) | (decr.) |
| North America, primarily United States | \$34,610 | \$27,988 | \$6,622 | 23.7 % | \$97,711 | \$84,777 | \$12,934 | 15.3 % |
| Europe, Middle East & Africa | 12,985 | 11,833 | 1,152 | 9.7 | 36,599 | 35,373 | 1,226 | 3.5 |
| Asia | 6,091 | 6,679 | (588) | (8.8) | 17,208 | 16,748 | 460 | 2.7 |
| Latin America | 852 | 1,385 | (533) | (38.5) | 4,894 | 4,191 | 703 | 16.8 |
| Total revenue | \$54,538 | \$47,885 | \$6,653 | 13.9 % | \$156,412 | \$141,089 | \$15,323 | 10.9 % |

Revenue in North America increased by \$6.6 million for the three months ended June 30, 2015 compared to the same period a year ago as certain customers made large purchases of cellular routers and gateway products, modules and serial servers. Revenue in North America increased by \$12.9 million for the nine months ended June 30, 2015 compared to the same period a year ago due to an increase in product revenue of \$14.7, partially offset by a decline of \$1.8 million in service revenue. The North America increase mostly related to large sales of our cellular routers and gateway products and RF products to certain customers. There was also an increase in modules and serial servers, partially offset by a decrease in service revenue.

Revenue in Europe, Middle East & Africa ("EMEA") increased by \$1.1 million and \$1.2 million for the three and nine month periods ended June 30, 2015, respectively, compared to the same period a year ago. This increase was primarily due to increased revenue from cellular-related products and embedded modules compared to the same period in the prior fiscal year, partially offset by the fluctuation of foreign currency rates, which had an unfavorable impact on total revenue of \$1.1 million for the three month period ended June 30, 2015 and \$2.6 million for the nine month period ended June 30, 2015 compared to the same periods a year ago, due to the weakening of the Euro and British Pound compared to the U.S. Dollar (see Item 3. under Foreign Currency Risk later in this Form 10-Q).

Revenue in Asia decreased by \$0.6 million for the three month period ended June 30, 2015 compared to the same period a year ago primarily due to cellular routers and gateway products. Revenue in Asia increased by \$0.5 million for the nine month period ended June 30, 2015 compared to the same period a year ago primarily related to an increase in revenue from modules, chips and serial servers.

Revenue in Latin America decreased by \$0.5 million for the three month period ended June 30, 2015 compared to the same period a year ago, and increased by \$0.7 million for the nine month period ended June 30, 2015 compared to the comparable nine month period a year ago. These fluctuations were attributable to timing of customer projects involving our cellular routers and gateway products.

GROSS MARGIN

Gross margins were 46.5% and 45.6% for the three and nine month periods ended June 30, 2015, respectively, compared to gross margins of 46.3% and 47.4% for the three and nine month periods ended June 30, 2014, respectively.

Hardware product gross margin was 48.5% and 48.0% for the three and nine month periods ended June 30, 2015, respectively, compared to 50.1% and 50.8% for the three and nine month periods ended June 30, 2014, respectively.

Generally our hardware growth products have a lower gross margin than our mature products. Our gross margins decreased as the mix of our hardware products has become increasingly weighted toward growth products, and we sold more growth products to higher volume customers. In the future we expect to focus more on securing larger and longer-term opportunities and that this may impact our gross margins negatively. Additionally, for the nine month period ended June 30, 2015, we incurred additional manufacturing expenses to recover from the impact of the Thailand fire that also reduced gross margin.

We received proceeds from a claim for business interruption insurance of \$0.3 million to compensate us for lost revenue associated with the fire at our subcontract manufacturer which took place in November 2014. This positively

impacted gross margin by 0.5% in the third fiscal quarter of 2015.

Service gross margin was 23.7% and 19.8% for the three and nine month periods ended June 30, 2015, respectively, compared to 9.5% and 18.7% for the three and nine month periods ended June 30, 2014, respectively. Service gross margin increased by 14.2 percentage points and 1.1 percentage points for the three and nine month periods ended June 30, 2015, respectively,

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

compared to the same periods a year ago, as a direct result of improved utilization of consulting labor in connection with our restructuring. We expect our service gross margin to vary from quarter to quarter for the foreseeable future as these margins are dependent on the utilization rates of our personnel.

OPERATING EXPENSES

The following summarizes our total operating expenses in dollars and as a percentage of total revenue:

| (\$ in thousands) | Three months ended June 30, | | | | \$ incr. (decr.) | Nine months ended June 30, | | | | \$ incr. (decr.) |
|----------------------------|-----------------------------|--------|----------|--------|---------------------|----------------------------|--------|----------|--------|---------------------|
| | 2015 | | 2014 | | | 2015 | | 2014 | | |
| Sales and marketing | \$9,434 | 17.3 % | \$9,859 | 20.6 % | \$(425) | \$30,525 | 19.5 % | \$30,477 | 21.6 % | \$48 |
| Research and development | 8,374 | 15.3 % | 7,253 | 15.1 % | 1,121 | 23,715 | 15.2 % | 21,921 | 15.5 % | 1,794 |
| General and administrative | 4,720 | 8.7 % | 5,317 | 11.1 % | (597) | 14,448 | 9.2 % | 14,659 | 10.4 % | (211) |
| Restructuring | (9) | NM | — | — | (9) | 509 | 0.3 % | 81 | 0.1 % | 428 |
| Total operating expenses | \$22,519 | 41.3 % | \$22,429 | 46.8 % | \$90 | \$69,197 | 44.2 % | \$67,138 | 47.6 % | \$2,059 |

NM means not meaningful.

Sales and marketing expenses decreased \$0.4 million for the three month period ended June 30, 2015 compared to the same period a year ago mostly related to a slight decrease in compensation-related expenses as a result of the recent restructuring, and decreases in both professional services and travel and entertainment expenses. Sales and marketing expenses remained mostly the same for the nine month period ended June 30, 2015 compared to the same period a year ago, primarily due to an increase in incentive compensation expenses due to improved company performance in fiscal 2015, partially offset by decreases in travel and entertainment expenses.

Research and development expenses increased \$1.1 million and \$1.8 million for both the three and nine month periods ended June 30, 2015 compared to the same periods a year ago, primarily due to a change in the mix of our engineering personnel as we closed our India office and hired replacement resources domestically. In addition, incentive compensation expenses increased due to improved company performance in fiscal 2015.

General and administrative expenses decreased \$0.6 million for the three month period ended June 30, 2015 compared to the same period a year ago, primarily due to CEO transition expenses that were recorded in the third quarter of fiscal 2014. For the nine month period ended June 30, 2015 compared to the same period a year ago, general and administrative expenses decreased by \$0.2 million. The decrease was primarily due to CEO transition expenses recorded in fiscal 2014 and reduced amortization expense as certain intangibles were fully amortized, partially offset by an increase in incentive compensation expense due to increased company performance and increased professional fees.

Restructuring expense was \$0.5 million for the nine month period ended June 30, 2015 and related to restructuring charges for our India and Etherios operations. In the nine month period ended June 30, 2014 there was a \$0.1 million restructuring expense pertaining to the fiscal 2014 restructuring activities (see Note 12 to our Condensed Consolidated Financial Statements).

OTHER INCOME (LOSS), NET

Other income (loss), net increased \$0.5 million and \$2.1 million for the three and nine month periods ended June 30, 2015, respectively, compared to the same periods a year ago primarily due to a gain from the settlement of a property and casualty insurance claim related to the replacement of our capital equipment destroyed in the fire at our subcontract manufacturer's location of \$0.4 million and \$1.4 million for the three and nine month periods ended June 30, 2015. For the nine months ended June 30, 2015, we also recorded foreign currency transaction gains in fiscal 2015 as the U.S. Dollar strengthened against the Euro and Yen.

INCOME TAXES

Income tax provision was \$0.8 million for the nine month period ended June 30, 2015. Net tax benefits specific to the nine months ended June 30, 2015 were \$0.9 million resulting from the reinstatement of the research and development

tax credit for calendar year 2014 and reversal of tax reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions. These discrete tax benefits were partially offset by a discrete tax expense for the adjustment of state rate on net deferred tax assets. For the nine month period ended June 30, 2015, our effective tax rate before items specific to the period was more than the U.S. statutory rate due primarily to mix of income between taxing jurisdictions, certain of which have higher

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

statutory tax rates than the U.S., an increase in permanent tax items and an increase in certain reserves for unrecognized tax benefits.

Income tax benefit was \$1.5 million for the nine month period ended June 30, 2014. Net tax benefits specific to the period of \$1.4 million related to the re-measurement and reversal of certain income tax reserves as a result of the conclusion in March 2014 of a federal income tax audit for fiscal 2012, a reversal of reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions and a valuation allowance reversal associated with the reassessment of state research and development tax credits. For the nine month period ended June 30, 2014, our effective tax rate before items specific to the period was more than the statutory rate primarily due to an adjustment for certain foreign income taxed at the U.S. rate and lower than expected benefits associated with certain state credits. Our effective tax rate will vary based on a variety of factors, including overall profitability, the geographical mix of income before taxes and related statutory tax rate in each jurisdiction, and tax items specific to the period, such as settlements of audits. We expect that we may record other benefits or expenses in the future that are specific to a particular quarter such as expiration of statutes of limitation, the completion of tax audits, or legislation that is enacted for both U.S. and foreign jurisdictions.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations and capital expenditures principally with funds generated from operations. At June 30, 2015, we had cash, cash equivalents and short-term marketable securities of \$91.3 million compared to \$80.4 million at September 30, 2014. Our working capital (total current assets less total current liabilities) was \$135.5 million at June 30, 2015 and \$125.9 million at September 30, 2014. We presently anticipate total fiscal 2015 capital expenditures will be approximately \$4.4 million, of which we spent \$3.9 million.

Net cash provided by operating activities was \$9.0 million and \$2.5 million for the nine month periods ended June 30, 2015 and 2014, respectively, a net increase of \$6.5 million. This was primarily due to a \$4.8 million increase in net income after adjustments for non-cash items and a \$1.7 million favorable change in operating assets and liabilities. The increase in cash provided by operating assets and liabilities of \$1.7 million was primarily due to a decrease in accounts receivable as a result of the timing of shipments and an increase in accrued liabilities associated with higher incentive compensation, partially offset by lower accounts payable.

Net cash used in investing activities was \$5.0 million during the nine months ended June 30, 2015 compared to net cash provided by investing activities of \$17.1 million during the nine months ended June 30, 2014, a net decrease of \$22.1 million. During the first nine months of fiscal 2015, we recorded net purchases of \$2.6 million for marketable securities and invested \$3.8 million for capital expenditures, partially offset by proceeds received from a property and casualty insurance settlement of \$1.4 million. During the first nine months of fiscal 2014, we received net proceeds of \$19.8 million from maturities of marketable securities, partially offset by \$2.7 million of capital expenditures.

Net cash provided by financing activities was \$4.7 million for the nine months ended June 30, 2015 compared to net cash used in financing activities of \$5.5 million for the nine months ended June 30, 2014, a net increase of \$10.2 million. During the first nine months of fiscal 2015, we had \$7.3 million fewer purchases of common stock and received \$2.9 million more proceeds from stock option plan and employee stock purchase plan transactions compared to the same period a year ago.

We generally expect positive cash flows from operations and believe that our current cash, cash equivalents and short-term marketable securities balances, cash generated from operations and our ability to secure debt and/or equity financing will be sufficient to fund our business operations and capital expenditures for the next twelve months and beyond. On October 28, 2014, our Board of Directors authorized a new program to repurchase up to \$15.0 million of our common stock primarily to return capital to shareholders and to support our employee stock purchase program. This authorization expires on October 31, 2015. We did not repurchase shares under this program during the first nine months of fiscal 2015. During the month of October 2014, we repurchased 287,787 shares under our prior board-approved stock repurchase program for \$2.3 million.

At June 30, 2015, our cash, cash equivalents and marketable securities, including long-term marketable securities, were \$100.8 million. This balance included approximately \$31.5 million of cash and cash equivalents held by our

controlled foreign subsidiaries of which \$28.8 million represents accumulated undistributed foreign earnings. Although we have no current need to do so, if we change our assertion that we do not intend to repatriate additional undistributed foreign earnings for cash requirements in the United States, we would have to accrue applicable taxes. The amount of any taxes and the application of

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

any tax credits would be determined based on the income tax laws at the time of such repatriation. Under current tax laws, we estimate the unrecognized deferred tax liability to be in the range of \$0.9 million to \$1.9 million.

Recently Issued Accounting Pronouncements

In April 2015, the Financial Accounting Standards Board ("FASB") issued ASU 2015-05, "Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40) - Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. The new standard provides guidance to customers about whether a cloud computing arrangement includes a software license. If the arrangement does include a software license, the software license element of the arrangement should be accounted for in the same manner as the acquisition of other software licenses. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, with early adoption permitted. We expect to adopt this guidance beginning with our fiscal quarter ending December 31, 2016. We do not expect this guidance to have a material impact on our consolidated financial statements.

In May 2014, FASB issued ASU 2014-09, "Revenue from Contracts with Customers." This guidance provides a five-step analysis in determining when and how revenue is recognized so that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods and services. It also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In July 2015, the FASB approved a one-year deferral of the effective date of ASU 2014-09, Revenue from Contracts with Customers. We can elect to adopt the provisions of ASU 2014-09 for annual periods beginning after December 15, 2017, including interim periods within that reporting period. The FASB also agreed to allow entities to choose to adopt the standard as of the original effective date. We are assessing the adoption date and potential impact of adopting this ASU on our consolidated financial statements and related disclosures.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

Our exposure to interest rate risk relates primarily to our investment portfolio. Our marketable securities are classified as available-for-sale and are carried at fair value. Our investments consist of money market funds, certificates of deposit, commercial paper, corporate bonds and government municipal bonds. Our investment policy specifies the types of eligible investments and minimum credit quality of our investments, as well as diversification and concentration limits which mitigate our risk. We do not use derivative financial instruments to hedge against interest rate risk because the majority of our investments mature in less than one year.

FOREIGN CURRENCY RISK

We are exposed to foreign currency transaction risk associated with certain sales transactions being denominated in Euros, British Pounds or Japanese Yen and in certain cases, transactions in U.S. Dollars in our foreign entities. We are also exposed to foreign currency translation risk as the financial position and operating results of our foreign subsidiaries are translated into U.S. Dollars for consolidation. We have not implemented a formal hedging strategy to reduce foreign currency risk as we continue to mitigate this risk with natural hedging strategies such as mitigating our net asset position in non-functional currencies.

For the nine months ended June 30, 2015 and 2014, we had approximately \$58.7 million and \$56.3 million, respectively, of revenue from foreign customers including export sales. Of these sales, \$16.9 million and \$18.0 million, respectively, were denominated in foreign currency, predominantly Euros and British Pounds. In future periods, we expect a significant portion of sales will continue to be made in both Euros and British Pounds.

Total revenue was unfavorably impacted by foreign currency translation of \$1.1 million and \$2.7 million for the three and nine month periods ended June 30, 2015, respectively, as compared to the same period in the prior fiscal year. The table below compares the average monthly exchange rates of the Euro, British Pound and Japanese Yen to the U.S. Dollar:

| | Nine months ended June 30, | | % increase |
|---------------|----------------------------|--------|------------|
| | 2015 | 2014 | (decrease) |
| Euro | 1.1626 | 1.3677 | (15.0)% |
| British Pound | 1.5447 | 1.6521 | (6.5)% |
| Japanese Yen | 0.0085 | 0.0098 | (13.3)% |

A 10% change from the first nine months of fiscal year 2015 average exchange rate for the Euro, British Pound and Japanese Yen to the U.S. Dollar would have resulted in a 1.1% increase or decrease in revenue and a 2.0% increase or decrease in stockholders' equity due to foreign currency translation. The above analysis does not take into consideration any pricing adjustments we might consider in response to changes in such exchange rates.

CREDIT RISK

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

Investments are made in accordance with our investment policy and consist of money market funds, certificates of deposit, commercial paper, corporate bonds and government municipal bonds. The fair value of our investments contains an element of credit exposure, which could change based on changes in market conditions. If market conditions deteriorate or if the issuers of these securities experience credit rating downgrades, we may incur impairment charges for securities in our investment portfolio. All of our securities are held domestically.

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ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief 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 Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective because of the material weakness in our internal control over financial reporting described below.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

The changes made to address the material weakness noted below constitute a change in our internal control over financial reporting during the three months ended June 30, 2015 that has materially affected, or is reasonably likely to affect, our internal control over financial reporting. There has been no other change in our internal control over financial reporting during the three months ended June 30, 2015.

MATERIAL WEAKNESS IN INTERNAL CONTROL OVER FINANCIAL REPORTING

As reported in our Form 10-K for the fiscal year ended September 30, 2014, we did not maintain effective controls over the preparation, review and analysis of income tax balances. Specifically, we did not maintain effective controls over the interim and annual reconciliation analysis and review of the components of our consolidated income taxes receivable account to ensure all account components existed and were recorded at their appropriate amounts in the consolidated financial statements. This material weakness could result in misstatement of the tax accounts and disclosures that would result in a material misstatement of the consolidated financial statements that would not be prevented or detected on a timely basis.

REMEDIATION OF MATERIAL WEAKNESS IN INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is actively engaged in planning and implementing remediation efforts to address the material weakness identified above. Management is underway with the following actions to address the material weakness:

- We have engaged a reputable firm to assist in performing responsibilities in our tax department, which provides us with more tax personnel and expertise than we previously had internally.

- We have added new controls to strengthen the reconciliation and review process over income tax accounts, including a checklist that will help ensure that all relevant tax controls and considerations have been addressed during each reporting period. Certain controls have also been re-designed to operate at a higher level of precision, resulting from enhanced account-level reviews and pre-closing processes to identify business events that may impact income taxes. Management believes that the actions described above, as implemented and when validated, will strengthen our internal control over financial reporting and remediate the identified material weakness.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 1A. RISK FACTORS

There have been no material changes in our risk factors from those previously disclosed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended September 30, 2014.

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

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

None

ITEM 5. OTHER INFORMATION

None

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| ITEM 6. | | EXHIBITS |
|-------------|-----|--|
| Exhibit No. | | Description |
| 3 | (a) | Restated Certificate of Incorporation of the Company, as amended (1) |
| 3 | (b) | Amended and Restated By-Laws effective December 17, 2014 (2) |
| 4 | (a) | Share Rights Agreement, dated as of April 22, 2008, between the Company and Wells Fargo Bank, N.A., as Rights Agent (3) |
| 4 | (b) | Form of Amended and Restated Certificate of Powers, Designations, Preferences and Rights of Series A Junior Participating Preferred Shares (4) |
| 10 | (a) | Transition Agreement between the Company and Steven E. Snyder dated March 25, 2015 (5)* |
| 10 | (b) | Offer Letter between the Company and Michael C. Goergen dated March 6, 2015 (6)* |
| 31 | (a) | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer |
| 31 | (b) | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer |
| 32 | | Section 1350 Certification |
| 101.INS | | XBRL Instance Document |
| 101.SCH | | XBRL Taxonomy Extension Schema Document |
| 101.CAL | | XBRL Taxonomy Calculation Linkbase Document |
| 101.DEF | | XBRL Taxonomy Definition Linkbase Document |
| 101.LAB | | XBRL Taxonomy Label Linkbase Document |
| 101.PRE | | XBRL Taxonomy Presentation Linkbase Document |

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

(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 3.2 to the Company's Current Report on Form 8-K filed December 5, 2014 (File No. 1-34033)

(3) Incorporated by reference to Exhibit 4(a) to the Company's Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)

(4) Incorporated by reference to Exhibit 4(b) to the Company's Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)

(5) Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed March 26, 2015 (File No. 1-34033)

(6) Incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed March 26, 2015 (File No. 1-34033)

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SIGNATURE

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

DIGI INTERNATIONAL INC.

Date: July 31, 2015

By: /s/ Michael C. Goergen
Michael C. Goergen
Senior Vice President, Chief Financial Officer and
Treasurer (Principal Financial Officer and Authorized
Officer)

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EXHIBIT INDEX

| Exhibit Number | Document Description | Form of Filing |
|----------------|--|---------------------------|
| 3 | (a) Restated Certificate of Incorporation of the Company, as Amended | Incorporated by Reference |
| 3 | (b) Amended and Restated By-Laws effective December 17, 2014 | 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) Transition Agreement between the Company and Steven E. Snyder dated March 25, 2015 | Incorporated by Reference |
| 10 | (b) Offer Letter between the Company and Michael C. Goergen dated March 6, 2015 | Incorporated by Reference |
| 31 | (a) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer | Filed Electronically |
| 31 | (b) Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer | Filed Electronically |
| 32 | Section 1350 Certification | Filed Electronically |
| 101.INS | XBRL Instance Document | Filed Electronically |
| 101.SCH | XBRL Taxonomy Extension Schema Document | Filed Electronically |
| 101.CAL | XBRL Taxonomy Calculation Linkbase Document | Filed Electronically |
| 101.DEF | XBRL Taxonomy Definition Linkbase Document | Filed Electronically |
| 101.LAB | XBRL Taxonomy Label Linkbase Document | Filed Electronically |
| 101.PRE | XBRL Taxonomy Presentation Linkbase Document | Filed Electronically |