

DIGI INTERNATIONAL INC
Form 10-Q
August 02, 2016

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, 2016
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

(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

On July 27, 2016, there were 25,961,970 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,	
	2016	2015	2016	2015
	(in thousands, except per share data)			
Revenue:				
Hardware product	\$50,547	\$50,001	\$147,526	\$143,042
Service	1,583	2,054	5,025	6,632
Total revenue	52,130	52,055	152,551	149,674
Cost of sales:				
Cost of hardware product	24,988	25,729	73,981	74,339
Cost of service	1,165	1,302	3,494	4,519
Total cost of sales	26,153	27,031	77,475	78,858
Gross profit	25,977	25,024	75,076	70,816
Operating expenses:				
Sales and marketing	8,627	8,982	25,310	29,092
Research and development	7,948	7,785	23,543	22,148
General and administrative	4,283	4,474	13,409	13,598
Restructuring (reversal) charge, net	(6	) (9	) 747	403
Total operating expenses	20,852	21,232	63,009	65,241
Operating income	5,125	3,792	12,067	5,575
Other (expense) income, net:				
Interest income	143	46	381	138
Interest expense	(100	) (4	) (226	) (4
Other (expense) income, net	(359	) 419	(520	) 2,131
Total other (expense) income, net	(316	) 461	(365	) 2,265
Income from continuing operations, before income taxes	4,809	4,253	11,702	7,840
Income tax provision	532	1,168	2,068	2,075
Income from continuing operations	4,277	3,085	9,634	5,765
Income (loss) from discontinued operations, after income taxes	—	(589	) 3,230	(2,162
Net income	\$4,277	\$2,496	\$12,864	\$3,603
Basic net income (loss) per common share:				
Continuing operations	0.17	0.12	\$0.38	\$0.24
Discontinued operations	—	(0.02	) \$0.13	\$(0.09
Net income (1)	\$0.17	\$0.10	\$0.50	\$0.15
Diluted net income (loss) per common share:				
Continuing operations	0.16	0.12	\$0.37	\$0.23
Discontinued operations	—	(0.02	) \$0.12	\$(0.09
Net income	\$0.16	\$0.10	\$0.49	\$0.14
Weighted average common shares:				
Basic	25,904	24,938	25,684	24,525

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Diluted 26,300 25,710 26,156 25,085

(1) Earnings per share presented are calculated by line item and may not add due to the use of rounded amounts.

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

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Table of ContentsDIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)

	Three months ended June 30,		Nine months ended June 30,	
	2016	2015	2016	2015
	(in thousands)			
Net income	\$4,277	\$2,496	\$12,864	\$3,603
Other comprehensive (loss) income, net of tax:				
Foreign currency translation adjustment	(1,272)	1,571	(1,718)	(4,158)
Change in net unrealized gain (loss) on investments	6	4	49	(2)
Less income tax (provision) benefit	(2)	(1)	(18)	1
Reclassification of realized loss (gain) on investments included in net income (1)	—	—	(7)	1
Less income tax benefit (2)	—	—	3	—
Other comprehensive (loss) income, net of tax	(1,268)	1,574	(1,691)	(4,158)
Comprehensive income (loss)	\$3,009	\$4,070	\$11,173	\$(555)

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

(2) Recorded in Income tax provision in our Condensed Consolidated Statements 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, 2016	September 30, 2015
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$61,072	\$ 45,018
Marketable securities	63,137	47,191
Accounts receivable, net	28,536	27,788
Inventories	25,957	31,877
Deferred tax assets	—	3,252
Receivable from sale of business	2,982	—
Other	4,338	3,435
Current assets of discontinued operations	—	1,624
Total current assets	186,022	160,185
Marketable securities, long-term	7,321	13,626
Property, equipment and improvements, net	13,557	14,339
Identifiable intangible assets, net	4,423	2,648
Goodwill	109,880	100,183
Deferred tax assets	8,278	6,255
Receivable from sale of business	1,949	—
Other	207	250
Non-current assets of discontinued operations	—	2,874
Total assets	\$331,637	\$ 300,360
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$8,720	\$ 6,673
Income taxes payable	—	828
Accrued compensation	9,769	10,156
Accrued warranty	1,135	1,014
Contingent consideration on acquired business	726	—
Other	3,594	3,037
Current liabilities of discontinued operations	—	1,481
Total current liabilities	23,944	23,189
Income taxes payable	1,431	1,546
Deferred tax liabilities	602	135
Contingent consideration on acquired business	9,861	—
Other non-current liabilities	856	457
Non-current liabilities of discontinued operations	—	95
Total liabilities	36,694	25,422
Contingencies (see Note 11)		
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; 32,413,708 and 31,534,198 shares issued	324	315

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Additional paid-in capital	236,058	227,367
Retained earnings	137,268	124,404
Accumulated other comprehensive loss	(24,304)	(22,613)
Treasury stock, at cost, 6,453,952 and 6,487,248 shares	(54,403)	(54,535)
Total stockholders' equity	294,943	274,938
Total liabilities and stockholders' equity	\$331,637	\$ 300,360

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

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Table of ContentsDIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine months ended June 30,	
	2016	2015
	(in thousands)	
Operating activities:		
Net income	\$12,864	\$3,603
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of property, equipment and improvements	2,088	2,170
Amortization of identifiable intangible assets	1,474	2,286
Stock-based compensation	2,663	3,262
Excess tax benefits from stock-based compensation	(202)	—
Deferred income tax provision	748	1,729
Gain in insurance settlement related to property and equipment	—	(1,375)
Gain on sale of business	(2,870)	—
Change in fair value of contingent consideration	187	—
Bad debt/product return provision	116	198
Inventory obsolescence	1,284	842
Restructuring charges, net	747	509
Other	89	(81)
Changes in operating assets and liabilities	1,395	(4,147)
Net cash provided by operating activities	20,583	8,996
Investing activities:		
Purchase of marketable securities	(56,256)	(31,054)
Proceeds from maturities of marketable securities	46,664	28,494
Proceeds from sale of investment	13	—
Proceeds from sale of business	2,849	—
Acquisition of business, net of cash acquired	(2,860)	—
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	(1,584)	(3,888)
Net cash used in investing activities	(11,174)	(5,003)
Financing activities:		
Excess tax benefits from stock-based compensation	202	—
Proceeds from stock option plan transactions	6,732	6,332
Proceeds from employee stock purchase plan transactions	688	708
Purchases of common stock	(546)	(2,339)
Net cash provided by financing activities	7,076	4,701
Effect of exchange rate changes on cash and cash equivalents	(431)	(2,429)
Net increase in cash and cash equivalents	16,054	6,265
Cash and cash equivalents, beginning of period	45,018	47,490
Cash and cash equivalents, end of period	\$61,072	\$53,755
Supplemental schedule of non-cash investing and financing activities:		
Receivable related to sale of business	\$4,931	\$—
Liability related to acquisition of business	\$(10,550)	\$—

Accrual for purchase of property, equipment, improvements and certain other intangible assets \$(38) \$—
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, 2015 as filed with the SEC (“2015 Financial Statements”).

On October 23, 2015, we sold all of the outstanding stock of our wholly owned subsidiary, Etherios Inc. (“Etherios”) to West Monroe Partners, LLC. Because the sale of Etherios represented a strategic shift that will have a major effect on our operations and financial results, we have classified our Etherios business as discontinued operations and have therefore segregated its operating results from continuing operations in our Condensed Consolidated Statements of Operations for all periods presented. We have also segregated the assets and liabilities of Etherios on our Condensed Consolidated Balance Sheet for September 30, 2015.

During the first fiscal quarter ended December 31, 2015, we adopted Accounting Standards Update (“ASU”) 2015-17, “Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes” on a prospective basis. As required by ASU 2015-17, all deferred tax assets and liabilities are classified on a jurisdictional basis as non-current in our condensed consolidated balance sheets, which is a change from our historical presentation whereby certain of our deferred tax assets and liabilities were classified as current and the remainder were classified as non-current. Our prior periods were not retrospectively adjusted.

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 2015 Financial Statements, but do not include all disclosures required by U.S. GAAP.

Contingent Consideration

We measure our contingent consideration liabilities recognized in connection with business combinations at fair value on a recurring basis using significant unobservable inputs classified within Level 3 of the fair value hierarchy as defined in ASC 320 “Investments - Debt and Equity Securities”. We used a probability-weighted discounted cash flow approach as a valuation technique to determine the fair value of the contingent consideration on the acquisition date. At each subsequent reporting period, the fair value is remeasured with the change in fair value recognized in general and administrative expense and interest expense in our Condensed Consolidated Statements of Operations. Amounts, if any, paid to the seller in excess of the amount recorded on the acquisition date will be classified as cash flows used in operating activities. Payments to the seller not exceeding the acquisition-date fair value of the contingent consideration will be classified as cash flows used in financing activities.

Recently Issued Accounting Pronouncements

Not Yet Adopted

In June 2016, the Financial Accounting Standards Board (“FASB”) issued ASU 2016-13, “Financial Instruments - Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments”. The amendments in this update replace

the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses. This update is intended to provide financial statement users with more decision-useful information about the expected credit losses. This ASU is effective for annual periods and interim periods for those annual periods beginning after December 15, 2019, which for us is

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

the first quarter ended December 31, 2020. Entities may early adopt beginning after December 15, 2018. We are currently evaluating the impact of the adoption of ASU 2016-13 on our consolidated financial statements.

In March 2016, FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting". This update includes provisions intended to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2016, which for us is the first fiscal quarter ending December 31, 2017. Early adoption is permitted. We are currently evaluating the impact of the adoption of ASU 2016-09 on our consolidated financial statements.

In February, 2016, FASB issued ASU 2016-02, "Leases (Topic 842)", which amends the existing guidance to require lessees to recognize lease assets and lease liabilities from operating leases on the balance sheet. This ASU is effective using the modified retrospective approach for annual periods and interim periods within those annual periods beginning after December 15, 2018, which for us is the first fiscal quarter ending December 31, 2019. Early adoption is permitted. We are currently evaluating the impact of the adoption of ASU 2016-02 on our consolidated financial statements.

In January 2016, FASB issued ASU 2016-01, "Financial Instruments-Overall: Recognition and Measurement of Financial Assets and Financial Liabilities." ASU 2016-01 will require equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. The amendments in this update will also simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, eliminate the requirement for public business entities to disclose the method and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet and require these entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes. This ASU would also change the presentation and disclosure requirements for financial instruments. In addition, this ASU clarifies the guidance related to valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, which for us is the first fiscal quarter ending December 31, 2018. Early adoption is permitted for financial statements of fiscal years and interim periods that have not been issued. We are currently evaluating the impact of the adoption of ASU 2016-01.

In July 2015, FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory." This provision would require inventory that was previously recorded using first-in, first-out ("FIFO") to be recorded at lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance is effective for fiscal years beginning after December 15, 2016 and interim periods within those years, which for us will be the first fiscal quarter ending December 31, 2017. The amendments in this guidance should be applied prospectively with earlier application permitted as of the beginning of an interim or annual period. We are currently evaluating the impact of the adoption of ASU 2015-11 and whether it would have a material impact on our consolidated financial statements.

In April 2015, 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 August 2014, FASB issued ASU 2014-15, "Presentation of Financial Statements - Going Concern." This guidance requires management to evaluate whether there is substantial doubt about a company's ability to continue as a going concern and to provide related footnote disclosures. These amendments are effective for the annual period ending after

December 15, 2016, and for annual periods and interim periods thereafter, which for us, will be our annual period ended September 30, 2017. Early adoption is permitted. While we are evaluating the impact of the adoption of ASU 2014-15, we do not expect it to have an 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

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

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 August 2015, the FASB issued ASU 2015-14 "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date" which approved a one-year deferral of the effective date of ASU 2014-09. As a result of this deferral, ASU 2014-09 is effective for our fiscal 2019, including interim periods within that reporting period. The FASB also agreed to allow us to choose to adopt the standard effective for our fiscal 2018. In addition, the FASB issued ASU 2016-08, ASU 2016-10 and ASU 2016-12 in March 2016, April 2016 and May 2016, respectively, to provide interpretive clarifications on the new guidance in ASC Topic 606. We will adopt the guidance beginning October 1, 2018 and are currently assessing the potential impact of adopting this ASU on our consolidated financial statements and related disclosures.

2. ACQUISITION

Acquisition of Bluenica Corporation

On October 5, 2015 we purchased all of the outstanding stock of Bluenica Corporation ("Bluenica"), a company focused on temperature monitoring of perishable goods in the food industry by using wireless sensors which are installed in grocery and convenience stores, restaurants, and in products during shipment and storage to ensure that quality, freshness and public health requirements are met. This acquisition forms the basis for our Digi Cold Chain Solutions. The terms of the acquisition included an upfront cash payment together with earn-out payments. Cash of \$2.9 million was paid at time of closing. The earn-out payments are scheduled to be paid in installments over a four-year period based on revenue achievement of the acquired business. Each of the earn-out payments will be calculated based on the revenue performance of Digi Cold Chain Solutions for each respective earn-out period. The cumulative amount of these earn-out payments will not exceed \$11.6 million. An additional payment, not to exceed \$3.5 million, may also be due depending on revenue performance. The fair value of this contingent consideration was \$10.4 million at the date of acquisition (see Note 7 to the Condensed Consolidated Financial Statements). We have determined that the earn-out will be considered as part of the purchase price consideration as there are no continuing employment requirements associated with the earn-out. Costs directly related to the acquisition, including legal, accounting and valuation fees, of approximately \$0.1 million have been charged directly to operations and are included in general and administrative expense in our Condensed Consolidated Statements of Operations in fiscal 2016.

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation resulted in the recognition of \$11.0 million of goodwill. We believe that the acquisition resulted in the recognition of goodwill because this is a complementary acquisition for us and will provide a source of recurring revenue in a new vertically focused solutions business.

Operating results for Bluenica, now known as Digi Cold Chain Solutions, are included in our Condensed Consolidated Statements of Operations from October 6, 2015. The Condensed Consolidated Balance Sheet as of June 30, 2016 reflects the final allocation of the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition.

The Bluenica acquisition has been accounted for using the acquisition method of accounting which requires, among other things, that assets acquired and liabilities assumed pursuant to the stock purchase agreement be recognized at fair value as of the acquisition date. During the third quarter of fiscal 2016, we finalized the purchase price allocation by recording adjustments to our deferred tax liabilities account as a result of the completion and filing of the last tax return for Bluenica.

2. ACQUISITION (CONTINUED)

The following table summarizes the values of Bluenica assets acquired and liabilities assumed as of the acquisition date (in thousands):

Cash	\$2,888
Purchase price payable upon completion of diligence matters	115
Fair value of contingent consideration on acquired business	10,400
Total purchase price consideration	\$13,403
Fair value of net tangible assets acquired	\$129
Fair value of identifiable intangible assets acquired:	
Purchased and core technology	2,000
Customer relationships	900
Goodwill	10,985
Deferred tax liabilities, net	(611)
Total	\$13,403

The weighted average useful life for all the identifiable intangibles listed above is 5.6 years. For purposes of determining fair value, the purchased and core technology identified above is assumed to have a useful life of five years and the customer relationships are assumed to have useful lives of seven years. Useful lives for identifiable intangible assets are estimated at the time of acquisition based on the periods of time from which we expect to derive benefits from the identifiable intangible assets.

We have determined that because the Bluenica acquisition is not material to our consolidated results of operations or financial position, pro forma financial information is not required to be presented.

3. DISCONTINUED OPERATIONS

On October 23, 2015, we sold all the outstanding stock of our wholly owned subsidiary, Etherios to West Monroe Partners, LLC. We sold Etherios as part of a strategy to focus on providing highly reliable machine connectivity solutions for business and mission-critical application environments. Etherios was included in our single operating segment.

Below is a summary of the gain on sale (in thousands):

Gross proceeds	\$4,096
Less:	
Employee related liabilities	(1,134)
Working capital adjustment	(113)
Net cash proceeds	2,849
Present value of receivable due on October 23, 2016	2,941
Present value of receivable due on October 23, 2017	1,922
Total fair value of consideration received	7,712
Less:	
Net assets of Etherios	(3,383)
Facility abandonment costs	(725)
Transaction costs, primarily professional fees	(734)
Gain on sale of discontinued operations, before income taxes	\$2,870

The terms of the sale agreement provide that West Monroe Partners LLC will pay us \$3.0 million on October 23, 2016 and \$2.0 million on October 23, 2017. The present value of these amounts is included within the total fair value of consideration received. These receivable amounts are unsecured and non-interest bearing. The carrying value of these receivables presented on our Condensed Consolidated Balance Sheet at June 30, 2016 approximates their fair values, which were determined using level 3 cash flow fair value measurement techniques.

3. DISCONTINUED OPERATIONS (CONTINUED)

Goodwill has been included in the net assets of Etherios based on the relative fair value of Etherios compared to the fair value of the Company, as the Company consists of a single reporting unit for goodwill impairment testing purposes.

As a condition to the sale agreement, we retained the operating leases in the Dallas and Chicago locations. Digi is no longer using these facilities and has sublet the Dallas location to West Monroe Partners, LLC through December 31, 2017. Also in connection with the sale, we assigned our San Francisco lease to West Monroe Partners, LLC. A remaining potential obligation exists in the event of a default under the assigned lease. However, we believe the likelihood of a liability related to this lease is remote. As of June 30, 2016, the future minimum lease payments for the San Francisco lease are approximately \$0.1 million.

Income (loss) from discontinued operations, after income taxes, as presented in the Condensed Consolidated Statements of Operations for the three and nine months ended June 30, 2016 and 2015 is as follows (in thousands):

	Three months ended June 30, 2016	Nine months ended June 30, 2016 2015	
Service revenue	\$-2,483	\$891	\$6,738
Cost of service	—2,158	713	6,205
Gross profit	—325	178	533
Operating expenses:			
Sales and marketing	—452	148	1,433
Research and development	—589	103	1,567
General and administrative	—246	43	850
Restructuring	—	—	106
Total operating expenses	—1,287	294	3,956
Loss from discontinued operations, before income taxes	—(962)	(116)	(3,423)
Gain on sale of discontinued operations, before income taxes	—	2,870	—
Total income (loss) from discontinued operations, before income taxes	—(962)	2,754	(3,423)
Income tax benefit on discontinued operations	—(373)	(476)	(1,261)
Income (loss) from discontinued operations, after income taxes	\$-(589)	\$3,230	\$(2,162)

Income tax benefit on discontinued operations for the nine months ended June 30, 2016 was \$0.5 million and primarily represents income tax benefits for deductible transaction costs, partially offset by a tax expense for equity awards for which we will not receive a tax deduction. For tax purposes, this transaction resulted in a capital loss, as the tax basis of the Etherios stock was higher than the book basis of the assets that were sold. Since we do not expect to be able to utilize this capital loss in the five year carryforward period, a deferred tax asset offset by a full valuation allowance was recorded in the third quarter of fiscal 2016 upon completion of the capital loss calculation.

3. DISCONTINUED OPERATIONS (CONTINUED)

At September 30, 2015, the carrying amounts of major classes of assets and liabilities of discontinued operations included in the Consolidated Balance Sheet was as follows (in thousands):

September 30, 2015

Current assets:

Accounts receivable, net	\$	1,417	
Deferred tax assets		127	
Other current assets		80	
Total current assets		1,624	
Property, equipment and improvements, net		18	
Identifiable intangible assets, net		1,531	
Goodwill		1,914	
Deferred tax assets (1)	(589)
Total assets of discontinued operations	\$	4,498	

Current liabilities:

Accounts payable	\$	50	
Accrued compensation		1,346	
Other current liabilities		85	
Total current liabilities		1,481	
Other non-current liabilities		95	
Total liabilities of discontinued operations	\$	1,576	

(1) As of September 30, 2015, we had a consolidated net deferred income tax asset related to the United States federal jurisdiction. That net deferred income tax asset position included a deferred income tax liability of \$589 thousand related to Etherios which was entirely in the United States federal tax jurisdiction.

The following table presents amortization, depreciation and purchases of property, equipment, improvements and certain other intangible assets of the discontinued operations related to Etherios (in thousands):

		Nine months ended June 30, 2016	2015
Amortization of identifiable intangible assets		\$30	\$362
Depreciation of property, equipment and improvements		\$—	\$21
Purchases of property, equipment, improvements and certain other intangible assets		\$—	\$(11)

4. 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.

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4. EARNINGS PER SHARE (CONTINUED)

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

	Three months ended June 30, 2016		Nine months ended June 30, 2015	
Numerator:				
Income from continuing operations	\$4,277	\$3,085	\$9,634	\$5,765
Income (loss) from discontinued operations, after income taxes	—	(589)	3,230	(2,162)
Net income	\$4,277	\$2,496	\$12,864	\$3,603
Denominator:				
Denominator for basic net income (loss) per common share — weighted average shares outstanding	25,904	24,938	25,684	24,525
Effect of dilutive securities:				
Stock options and restricted stock units	396	772	472	560
Denominator for diluted net income (loss) per common share — adjusted weighted average shares	26,300	25,710	26,156	25,085
Basic net income (loss) per common share:				
Continuing operations	\$0.17	\$0.12	\$0.38	\$0.24
Discontinued operations	\$—	\$(0.02)	\$0.13	\$(0.09)
Net income (1)	\$0.17	\$0.10	\$0.50	\$0.15
Diluted net income (loss) per common share:				
Continuing operations	\$0.16	\$0.12	\$0.37	\$0.23
Discontinued operations	\$—	\$(0.02)	\$0.12	\$(0.09)
Net income	\$0.16	\$0.10	\$0.49	\$0.14

(1) Earnings per share presented are calculated by line item and may not add due to the use of rounded amounts.

For the three months ended June 30, 2016 and 2015, there were 1,829,631 and 2,416,518 potentially dilutive shares, respectively, and for the nine months ended June 30, 2016 and 2015, there were 1,806,131 and 3,451,827 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.

5. SELECTED BALANCE SHEET DATA

The following table shows selected balance sheet data (in thousands):

	June 30, September 30, 2016 2015	
Accounts receivable, net:		
Accounts receivable	\$28,739	\$ 28,073
Less allowance for doubtful accounts	203	285
Accounts receivable, net	\$28,536	\$ 27,788
Inventories:		
Raw materials	\$21,276	\$ 26,037
Work in process	228	598
Finished goods	4,453	5,242
Inventories	\$25,957	\$ 31,877

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

Table of Contents**6. 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, 2016, 22 of our 61 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 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 income (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. Our balance sheet classification of available for sale securities is based on our best estimate of when we expect to liquidate such investments and, presently, is consistent with the stated maturity dates of such investments.

However, we are not committed to holding these investments until their maturity and may determine to liquidate some or all of these investments earlier based on our liquidity and other needs. During the nine months ended June 30, 2016 and 2015, we received proceeds from our available-for-sale marketable securities of \$46.7 million and \$28.5 million, respectively.

At June 30, 2016 our marketable securities were (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses	Fair Value (1)
Current marketable securities:				
Corporate bonds	\$ 34,116	\$ —	\$ (43)	\$ 34,073
Commercial paper	23,966	—	(12)	23,954
Certificates of deposit	2,005	1	—	2,006
Government municipal bonds	3,106	—	(2)	3,104
Current marketable securities	63,193	1	(57)	63,137
Non-current marketable securities:				
Certificates of deposit	7,275	46	—	7,321
Total marketable securities	\$ 70,468	\$ 47	\$ (57)	\$ 70,458

(1) Included in amortized cost and fair value is purchased and accrued interest of \$282.

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6. MARKETABLE SECURITIES (CONTINUED)

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

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses	Fair Value (1)
Current marketable securities:				
Corporate bonds	\$ 31,753	\$ —	\$ (39)	\$31,714
Commercial paper	7,986	—	(1)	7,985
Certificates of deposit	6,253	8	—	6,261
Government municipal bonds	1,232	—	(1)	1,231
Current marketable securities	47,224	8	(41)	47,191
Non-current marketable securities:				
Corporate bonds	4,138	—	(12)	4,126
Certificates of deposit	7,511	2	(6)	7,507
Government municipal bonds	1,996	—	(3)	1,993
Non-current marketable securities	13,645	2	(21)	13,626
Total marketable securities	\$ 60,869	\$ 10	\$ (62)	\$60,817

(1) Included in amortized cost and fair value is purchased and accrued interest of \$252.

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, 2016			
	Less than 12 Months		More than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	\$32,214	\$ (43)	\$ —	—
Commercial paper	23,954	(12)	—	—
Government municipal bonds	1,876	(2)	—	—
Total	\$58,044	\$ (57)	\$ —	—
	September 30, 2015			
	Less than 12 Months		More than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	\$33,664	\$ (52)	\$—	\$ —
Commercial paper	5,987	(1)	—	—
Certificates of deposit	4,244	(6)	499	(1)
Government municipal bonds	3,159	(3)	—	—
Total	\$47,054	\$ (62)	\$499	\$ (1)

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7. 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 and to financial liabilities for contingent consideration. These items are stated at fair value at each reporting period using the above guidance.

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

	Total carrying value at June 30, 2016	Fair Value Measurements Using Inputs Considered as		
		Level 1	Level 2	Level 3
Assets:				
Money market	\$ 27,646	\$ 27,646	\$ —	\$ —
Corporate bonds	34,073	—	34,073	—
Commercial paper	23,954	—	23,954	—
Certificates of deposit	9,327	—	9,327	—
Government municipal bonds	3,104	—	3,104	—
Total assets measured at fair value	\$ 98,104	\$ 27,646	\$ 70,458	\$ —
Liabilities:				
Contingent consideration on acquired business	10,587	\$ —	\$ —	\$ 10,587
Total liabilities measured at fair value	\$ 10,587	\$ —	\$ —	\$ 10,587

	Total carrying value at September 30, 2015	Fair Value Measurements Using Inputs Considered as		
		Level 1	Level 2	Level 3
Assets:				
Money market	\$ 14,436	\$ 14,436	\$ —	\$ —
Corporate bonds	35,840	—	35,840	—
Commercial paper	7,985	—	7,985	—

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Certificates of deposit	13,768	—	13,768	—
Government municipal bonds	3,224	—	3,224	—
Total assets measured at fair value	\$ 75,253	\$14,436	\$60,817	\$ —

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

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7. FAIR VALUE MEASUREMENTS (CONTINUED)

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, 2016.

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 or contingent consideration, currently and in the future. If market conditions deteriorate, we may incur impairment charges for securities in our investment portfolio. We may also incur changes to our contingent consideration liability as discussed below.

In connection with the Bluenica acquisition discussed in Note 2, we are required to make contingent payments over a period of up to four years, subject to Digi Cold Chain Solutions achieving specified revenue thresholds. The fair value of the liability for contingent payments recognized upon acquisition was \$10.4 million, and was estimated by discounting to present value the probability-weighted contingent payments expected to be made. Assumptions used in this calculation included the discount rate and various probability factors. This liability is considered to be a Level 3 financial liability that is re-measured each reporting period.

The following table presents a reconciliation of the liability measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended June 30, 2016 (in thousands):

	Three months ended June 30, 2016	Nine months ended June 30, 2016
Fair value at beginning of period	\$10,522	\$—
Purchase price contingent consideration	—	10,400
Change in fair value of contingent consideration	65	187
Fair value at end of period	\$10,587	\$10,587

The change in fair value of contingent consideration for the acquisition of Bluenica is included in general and administrative and interest expense on our Condensed Consolidated Statements of Operations and reflects our estimate of the probability of achieving the relevant targets and is discounted based on our estimated discount rate. We have estimated the fair value of the contingent consideration based on the probability of achieving the specified revenue thresholds at 93.6% to 98.1%. A significant increase (decrease) in our estimates of achieving the relevant targets could materially increase (decrease) the fair value of the contingent consideration liability.

8. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS, NET

Amortizable identifiable intangible assets were (in thousands):

	June 30, 2016			September 30, 2015		
	Gross carrying amount	Accum. amort.	Net	Gross carrying amount	Accum. amort.	Net
Purchased and core technology	\$46,772	\$(45,050)	\$1,722	\$45,449	\$(45,424)	\$25
License agreements	18	(4)	14	18	(4)	14
Patents and trademarks	11,689	(10,858)	831	11,377	(10,385)	992
Customer relationships	17,559	(15,703)	1,856	17,090	(15,473)	1,617
Total	\$76,038	\$(71,615)	\$4,423	\$73,934	\$(71,286)	\$2,648

Amortization expense was \$0.5 million and \$0.6 million for the three month periods ended June 30, 2016 and 2015, respectively. Amortization expense was \$1.4 million and \$1.9 million for the nine month periods ended June 30, 2016 and 2015, respectively. Amortization expense is recorded on our consolidated statements of operations within cost of sales and in general and administrative expense.

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8. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS, NET (CONTINUED)

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2016 and the five succeeding fiscal years is (in thousands):

2016 (three months)	\$ 396
2017	1,376
2018	910
2019	730
2020	681
2021	131

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

	Nine months ended	
	June 30,	
	2016	2015
Beginning balance, October 1	\$100,183	\$101,484
Acquisition of Bluenica	10,985	—
Foreign currency translation adjustment	(1,288)	(901)
Ending balance, June 30	\$109,880	\$100,583

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, 2016, our market capitalization was \$278.6 million compared to our carrying value of \$294.9 million. Our market capitalization plus our estimated control premium of 35% (discussed in the paragraphs below) resulted in a fair value in excess of our carrying value by a margin of 27%. 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

Table of Contents**8. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS, NET (CONTINUED)**

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.

During the third quarter of fiscal 2016, we reviewed recent control premium data for transactions that occurred during fiscal 2016 in the industries previously described. The data indicated that our current control premium of 35 percent continues to be indicative of the amount that an investor would pay to obtain a controlling interest based on current macroeconomic and industry data.

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.

9. INCOME TAXES

Income tax provision for continuing operations was \$2.1 million, or 17.7%, for the nine months ended June 30, 2016. Net tax benefits specific to the nine months ended June 30, 2016 were \$1.2 million resulting primarily from the reinstatement of the federal research and development tax credit for calendar year 2015 and the reversal of tax reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions. In addition, we filed an amended income tax return resulting in an additional domestic refund related to qualified manufacturing activities. For the nine months ended June 30, 2016, our continuing operations effective tax rate before items specific to the period was less than the U.S. statutory rate due primarily in the mix of income between taxing jurisdictions, certain of which have lower statutory tax rates than the U.S. and an increase in certain tax credits in the U.S.

Income tax provision for continuing operations was \$2.1 million, or 26.5%, for the nine months ended June 30, 2015. Net tax benefits specific to the period of \$0.9 million included a reversal of reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions and the reinstatement of the federal research and development tax credit for calendar year 2014, partially offset by a tax expense specific to the period for the adjustment of state rate on net deferred tax assets. For the nine months ended June 30, 2015, our continuing operations effective tax rate before items specific to the period was more than the statutory rate primarily due to a mix of income between foreign jurisdictions and lower than expected benefits associated with certain tax credits in the U.S.

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.

During the first quarter of fiscal 2016, we adopted ASU 2015-17 on a prospective basis. As required by ASU 2015-17, all deferred tax assets and liabilities are classified on a jurisdictional basis as non-current in our condensed consolidated balance sheets, which is a change from our historical presentation whereby certain of our deferred tax assets and liabilities were classified as current and the remainder were classified as non-current. Our prior periods were not retrospectively adjusted.

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

Unrecognized tax benefits as of September 30, 2015 \$1,618

Increases related to:

Prior year income tax positions 107

Decreases related to:

Expiration of statute of limitations	(121)
Unrecognized tax benefits as of June 30, 2016	\$1,604

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Table of Contents**9. INCOME TAXES (CONTINUED)**

The total amount of unrecognized tax benefits that, if recognized, would affect our effective tax rate is \$1.4 million, after considering the impact of interest and deferred benefit items. We expect the change in the total amount of unrecognized tax benefits will be insignificant over the next 12 months.

10. 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.

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, 2016	\$ 944	\$ 404	\$ (213)	\$ 1,135
Three months ended June 30, 2015	\$ 923	\$ 276	\$ (192)	\$ 1,007

Period	Balance at October 1	Warranties issued	Settlements made	Balance at June 30
Nine months ended June 30, 2016	\$ 1,014	\$ 696	\$ (575)	\$ 1,135
Nine months ended June 30, 2015	\$ 862	\$ 773	\$ (628)	\$ 1,007

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.

11. CONTINGENCIES

On December 23, 2015, JSDQ Mesh Technologies LLC filed a complaint naming us as a defendant in federal court in the District of Delaware. The complaint included allegations against us and one other company pertaining to the infringement of four patents relating to mesh networking technology. On April 27, 2016, we settled the claim pertaining to the infringement of the four patents. The settlement fully resolves the claim by JSDQ Mesh Technologies LLC with no future payment obligations. The settlement amount, which is not material to our operations or financial position, was paid on April 28, 2016.

In addition to the matter discussed above, 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.

12. STOCK-BASED COMPENSATION

Stock-based awards were granted under the 2016 Omnibus Incentive Plan (the "2016 Plan") beginning February 1, 2016 and prior to that were granted under the 2014 Omnibus Incentive Plan (the "2014 Plan"). Upon stockholder approval of the 2016 Plan, we ceased granting awards under any prior plan. The authority to grant options under the 2016 Plan and to set other terms and conditions rests with the Compensation Committee of the Board of Directors.

The 2016 Plan authorizes the issuance of up to 1,500,000 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 2016 Plan typically vest over a four-year period and will expire if unexercised after seven years from the date of grant. Restricted stock unit awards (“RSUs”) that have been granted to directors typically vest in one year. RSUs that have been granted to executives and employees typically vest in November over a four-year period. Awards may be granted under the 2016 Plan

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12. STOCK-BASED COMPENSATION (CONTINUED)

until January 31, 2026. Options under the 2016 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.

The 2014 Plan, under which grants ceased upon approval of the 2016 Plan, authorized 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 included our employees, our affiliates, non-employee directors of our Company and any consultant or advisor who is a natural person and provided services to us or our affiliates. Options that were granted under the 2014 Plan typically vested over a four year service period and expire if unexercised after eight years from the date of grant. RSUs that were granted to directors typically vested in one year. RSUs that were granted to executives and employees typically vested in November over a four-year period. Options under the 2014 Plan could be granted as either ISOs or NSOs. The exercise price of options and the grant date price of restricted stock was determined by our Compensation Committee and was not less than the fair market value of our common stock based on the closing price on the date of grant. Upon exercise, we issued 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. During the nine months ended June 30, 2016, our employees forfeited 47,172 shares in order to satisfy \$0.5 million of withholding tax obligations related to stock-based compensation, pursuant to terms of awards under our board and shareholder-approved compensation plans. As of June 30, 2016, there were approximately 1,352,631 shares available for future grants under the 2016 Plan.

Cash received from the exercise of stock options was \$6.7 million during the nine months ended June 30, 2016 and \$6.3 million during the nine months ended June 30, 2015. There were \$0.2 million in excess tax benefits from stock-based compensation for the nine months ended June 30, 2016. There were no excess tax benefits from stock-based compensation during the nine months ended June 30, 2015.

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 both the nine month periods ended June 30, 2016 and 2015. Pursuant to the Purchase Plan, 80,468 and 97,383 common shares were issued to employees during the nine months ended June 30, 2016 and 2015, respectively. Shares are issued under the Purchase Plan from treasury stock. As of June 30, 2016, 537,063 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,	
	2016	2015	2016	2015
Cost of sales	\$54	\$53	\$159	\$166
Sales and marketing	239	272	665	905
Research and development	144	134	439	425
General and administrative	507	474	1,395	1,451
Stock-based compensation before income taxes	944	933	2,658	2,947
Income tax benefit	(308)	(324)	(858)	(1,018)
Stock-based compensation after income taxes	\$636	\$609	\$1,800	\$1,929

Stock-based compensation cost capitalized as part of inventory was immaterial as of June 30, 2016 and September 30, 2015.

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12. STOCK-BASED COMPENSATION (CONTINUED)

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, 2015	4,800	\$10.21		
Granted	513	11.50		
Exercised	(720)	9.70		
Forfeited / Canceled	(606)	11.03		
Balance at June 30, 2016	3,987	\$10.34	4.7	\$ 4,299
Exercisable at June 30, 2016	2,848	\$10.50	3.9	\$ 2,777

(1) The aggregate intrinsic value represents the total pre-tax intrinsic value, based on our closing stock price of \$10.73 as of June 30, 2016, 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, 2016 was \$1.8 million and during the nine months ended June 30, 2015 was \$0.8 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,	
	2016	2015
Weighted average per option grant date fair value	\$3.92	\$2.98
Assumptions used for option grants:		
Risk free interest rate	1.41% - 1.85%	1.57% - 1.85%
Expected term	6.00 years	6.00 years
Expected volatility	32% - 33%	32% - 36%
Weighted average volatility	32%	35%
Expected dividend yield	0	0

The fair value of each option award granted during the periods presented was estimated using the Black-Scholes option valuation model that uses the assumptions noted in the table above. Expected volatilities are based on the historical volatility of our stock. We use historical data to estimate option exercise and employee termination information within the valuation model. 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, 2016 was 10.0%. As of June 30, 2016 the total unrecognized compensation cost related to non-vested stock options, net of expected forfeitures, was \$3.1 million and the related weighted average period over which it is expected to be recognized is approximately 3.1 years.

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12. STOCK-BASED COMPENSATION (CONTINUED)

A summary of our non-vested restricted stock units as of June 30, 2016 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, 2015	543	\$ 8.41
Granted	236	\$ 10.92
Vested	(179)	\$ 8.50
Canceled	(103)	\$ 8.12
Nonvested at June 30, 2016	497	\$ 9.63

As of June 30, 2016, the total unrecognized compensation cost related to non-vested restricted stock units was \$3.2 million and the related weighted average period over which it is expected to be recognized is approximately 1.5 years.

13. RESTRUCTURING

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

	Q2 2016 Restructuring Employee Termination Costs	Q1 2016 Restructuring Employee Termination Costs	Other	Total
Balance at September 30, 2015	\$ —	\$ —	\$ —	\$—
Restructuring charge	—	480	171	651
Balance at December 31, 2015	—	480	171	651
Restructuring charge	78	—	24	102
Payments	(76)	(113)	(195)	(384)
Foreign currency fluctuation	—	13	—	13
Balance at March 31, 2016	\$ 2	\$ 380	\$ —	\$382
Payments	(2)	(368)	—	(370)
Reversals	—	(6)	—	(6)
Foreign currency fluctuation	—	(6)	—	(6)
Balance at June 30, 2016	\$ —	\$ —	\$ —	\$—

Q1 2016 Restructuring

In November 2015, we approved a restructuring plan impacting our corporate staff. The plan closed our Dortmund, Germany office and relocated certain employees to our Munich office. We also recorded a contract termination charge as we relocated employees in our Minneapolis, Minnesota office to our corporate headquarters in Minnetonka, Minnesota in December 2015. We recorded a restructuring charge of \$0.7 million that included \$0.5 million of severance and \$0.2 million of contract termination costs during the first quarter of fiscal 2016. This restructuring resulted in an elimination of approximately 10 positions. The payments associated with these charges were completed in the third quarter of fiscal 2016.

Q2 2016 Restructuring

In January 2016, we approved a restructuring plan impacting our wireless design services group. This restructuring resulted in an elimination of 5 positions. We recorded a restructuring charge of \$0.1 million related to severance during the second quarter of fiscal 2016 and paid the majority of the severance during that same quarter.

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14. COMMON STOCK REPURCHASE

On April 26, 2016, 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. This new repurchase authorization expires on May 1, 2017. Shares repurchased under the new program may be made through 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. There were no shares repurchased under this program as of June 30, 2016.

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

Our management's discussion and analysis should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended September 30, 2015, as well as our subsequent reports on Forms 10-Q and 8-K and any amendments thereto.

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 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 or divestitures, 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, 2015, 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.

Presentation of Non-GAAP Financial Measures

This report includes Adjusted EBITDA from continuing operations, which is a non-GAAP measure. We understand that there are material limitations on the use of non-GAAP measures. Non-GAAP measures are not substitutes for GAAP measures, such as net income, for the purpose of analyzing financial performance. The disclosure of these

measures does not reflect all charges and gains that were actually recognized by the company. Non-GAAP measures are not prepared in accordance with, or an alternative for measures prepared in accordance with, generally accepted accounting principles and may be different from non-GAAP measures used by other companies. In addition, non-GAAP measures are not based on any comprehensive set of accounting rules or principles. We believe that non-GAAP measures have limitations in that they do not reflect all of the amounts associated with our results of operations as determined in accordance with GAAP and that these measures should only be used to evaluate our results of operations in conjunction with the corresponding GAAP measures. Additionally, we understand that Adjusted EBITDA from continuing operations does not reflect our cash expenditures, the cash requirements for

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

the replacement of depreciated and amortized assets, or changes in or cash requirements for our working capital needs. We believe that the presentation of Adjusted EBITDA from continuing operations as a percentage of revenue is useful because it provides a reliable and consistent approach to measuring our performance from year to year and in assessing our performance against that of other companies. We believe this information helps