DIGITAL RIVER INC /DE
Form 10-Q
August 06, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2013

OR

o 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 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**41-1901640**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

10380 BREN ROAD WEST
MINNETONKA, MINNESOTA 55343
(Address of principal executive offices)

(952) 253-1234
(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 filing requirements for the past 90 days. Yes x No o

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 x No o

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

The number of shares of common stock outstanding at July 1, 2013, was 34,251,416 shares.

Table of Contents

DIGITAL RIVER, INC.

Form 10-Q

Index

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DIGITAL RIVER, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	(Unaudited) June 30, 2013	December 31, 2012
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 422,847	$ 542,851
Short-term investments	147,351	162,794
Accounts receivable, net of allowance of $6,159 and $5,400	64,787	60,656
Deferred tax assets	416	457
Prepaid expenses and other	34,092	33,714
Total current assets	669,493	800,472
Property and equipment, net	56,200	53,265
Goodwill	138,307	108,960
Intangible assets, net of accumulated amortization of $94,765 and $91,059	33,747	11,718
Long-term investments	52,575	71,735
Deferred income taxes	888	1,724
Other assets	2,942	4,342
TOTAL ASSETS	$ 954,152	$ 1,052,216
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 134,553	$ 205,377
Accrued payroll	14,140	11,630
Deferred revenue	13,550	13,426
Other accrued liabilities	61,717	51,640
Total current liabilities	223,960	282,073
NON-CURRENT LIABILITIES		
Senior convertible notes	304,555	309,909
Other liabilities	23,146	18,236
Total non-current liabilities	327,701	328,145
TOTAL LIABILITIES	551,661	610,218
STOCKHOLDERS EQUITY		
Preferred stock, $.01 par value; 5,000,000 shares authorized; no shares issued or outstanding	0	0
Common stock, $.01 par value; 120,000,000 shares authorized; 50,023,146 and 48,941,402 shares issued	500	489
Treasury stock at cost; 15,771,730 and 13,581,889 shares	(404,220)	(368,721)

Additional paid-in capital		751,898		737,499
Retained earnings		63,664		75,901
Accumulated other comprehensive income (loss)		(9,351)		(3,170)
Total stockholders equity		402,491		441,998
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	954,152	$	1,052,216

See accompanying notes to consolidated financial statements.

Table of Contents

DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data; unaudited)

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Revenue	$ 92,471	$ 90,774	$ 206,164	$ 193,217
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	17,585	16,125	40,525	34,547
Network and infrastructure	14,490	12,932	29,751	25,689
Sales and marketing	27,222	27,204	58,056	55,932
Product research and development	18,156	15,416	35,955	31,419
General and administrative	14,293	11,414	32,921	23,584
Goodwill impairment			21,249	
Depreciation and amortization	5,088	4,950	10,118	10,289
Amortization of acquisition-related intangibles	2,283	1,743	4,211	3,592
Total costs and expenses	99,117	89,784	232,786	185,052
Income (loss) from operations	(6,646)	990	(26,622)	8,165
Interest income	780	996	1,376	2,135
Interest expense	(1,964)	(2,254)	(3,942)	(4,494)
Other income (expense), net	6,100	1,030	17,014	733
Income (loss) before income taxes	(1,730)	762	(12,174)	6,539
Income tax expense (benefit)	(858)	562	63	1,602
Net income (loss)	$ (872)	$ 200	$ (12,237)	$ 4,937
Net income (loss) per share - basic	$ (0.03)	$ 0.01	$ (0.37)	$ 0.15
Net income (loss) per share - diluted	$ (0.03)	$ 0.01	$ (0.37)	$ 0.15
Shares used in per-share calculation - basic	32,478	33,453	32,816	33,629
Shares used in per-share calculation - diluted	32,478	33,561	32,816	33,821

See accompanying notes to consolidated financial statements.

Table of Contents

DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands; unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Net income (loss)	$ (872)	$ 200	$ (12,237)	$ 4,937
Other comprehensive income (loss):				
Unrealized foreign currency translation gain (loss)	(20)	(17,702)	(8,225)	(7,697)
Unrealized gain (loss) on investments	(406)	(3,256)	3,097	(6,287)
Tax benefit (expense)	(1,052)	1,087	(1,053)	2,629
Other comprehensive income (loss)	(1,478)	(19,871)	(6,181)	(11,355)
Comprehensive income (loss)	$ (2,350)	$ (19,671)	$ (18,418)	$ (6,418)

See accompanying notes to consolidated financial statements.

Table of Contents

DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands; unaudited)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
OPERATING ACTIVITIES		
Net income (loss)	$ (12,237)	$ 4,937
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization of acquisition-related intangibles	4,211	3,592
Provision for doubtful accounts	928	900
Depreciation and amortization	10,118	10,289
Impairment of goodwill	21,249	
Debt issuance cost amortization	855	987
Amortization of investment premiums	1,524	
Loss on sale of equipment	69	
Gain on sale of investment	(17,526)	
Stock-based compensation expense	11,954	12,192
Excess tax benefits from stock-based compensation		(103)
Deferred and other income taxes	(1,765)	48
Change in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(9,577)	(8,434)
Prepaid and other assets	1,843	(5,598)
Accounts payable	(70,292)	(72,606)
Deferred revenue	(1,460)	4,917
Income tax payable	175	2,061
Other accrued liabilities	(4,000)	(5,029)
Net cash provided by (used in) operating activities	(63,931)	(51,847)
INVESTING ACTIVITIES		
Purchases of investments	(53,243)	(80,602)
Sales of investments	66,847	88,501
Cash received for cost method investments	39,636	
Cash paid for acquisitions, net of cash received	(55,843)	
Purchases of equipment and capitalized software	(13,167)	(6,150)
Net cash provided by (used in) investing activities	(15,770)	1,749
FINANCING ACTIVITIES		
Repurchase of convertible senior notes	(5,354)	
Exercise of stock options	1,273	1,509
Sales of common stock under employee stock purchase plan	1,183	1,300
Repurchase of common stock	(31,238)	(20,242)
Repurchase of restricted stock to satisfy tax withholding obligation	(4,261)	(3,530)
Excess tax benefits from stock-based compensation		103
Net cash provided by (used in) financing activities	(38,397)	(20,860)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(1,906)	(4,693)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(120,004)	(75,651)
CASH AND CASH EQUIVALENTS, beginning of period	542,851	497,193
CASH AND CASH EQUIVALENTS, end of period	$ 422,847	$ 421,542

SUPPLEMENTAL DISCLOSURES				
Cash paid for interest on senior convertible notes	$	3,068	$	3,505
Cash paid for income taxes	$	1,357	$	1,867

See accompanying notes to consolidated financial statements.

Table of Contents

1. BASIS OF PRESENTATION

The unaudited consolidated financial statements included herein reflect all adjustments, including normal recurring adjustments, which in our opinion are necessary to fairly state our consolidated financial position, results of operations and cash flows for the periods presented. These consolidated financial statements should be read in conjunction with our audited consolidated financial statements included in our Form 10-K for the year ended December 31, 2012, as filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2013, are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2013. The December 31, 2012, information was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles (GAAP) in the United States.

Summary of Significant Accounting Policies

A detailed description of our significant accounting policies can be found in our most recent Annual Report filed on Form 10-K for the fiscal year ended December 31, 2012. There was no material changes in significant accounting policies during the quarter ended June 30, 2013.

Revenue

Revenue Recognition. We recognize revenue from services rendered once all the following criteria for revenue recognition have been met: (1) persuasive evidence of an agreement exists; (2) the services have been rendered; (3) the fee is fixed and determinable; and, (4) collection of the amounts due is reasonably assured.

We also determine whether it is appropriate to record the gross amount of product sales and related costs or the net amount earned as net revenue. We typically are the seller and merchant of record on most of the transactions we process and have contractual relationships with our clients, which obligate us to pay to the client a specified percentage of each sale. We derive our revenue primarily from transaction fees based on a percentage of the product s sale price and fees from services rendered associated with the e-commerce and other services provided to our clients and end customers. Our revenue is recorded net as generally our clients are subject to inventory risks and control customers product choices. We sell both physical and digital products. Revenue is recognized upon fulfillment and based upon when products are shipped and title and significant risk of ownership passes to the customer.

The Company also provides customers with various proprietary software backup services. We recognize revenue for these backup services based upon historical usage within the contract period of the digital backup services when this information is available. Digital backup services are recognized straight-line over the life of the backup service when historical usage information is unavailable. Shipping revenues are recorded net of any associated costs.

We also, to a lesser extent, provide fee-based client services, which include website design, custom development and integration, analytical marketing, affiliate marketing and email marketing services. If we receive payments for fee-based services in advance of delivery, these amounts, if significant, are deferred and recognized over the service period.

Client service arrangements can have multiple deliverables such as delivery of website design or administrative site set up activities in connection with hosted reseller arrangements. These deliverables do not meet the criteria of separate units of accounting under GAAP. We account for these deliverables as one unit of accounting, as they generally only have value to the client during the time the hosted commerce site launches and commerce transactions occur. Therefore, associated revenue is recorded over the term of the hosting contract. Client services are executed through signed contractual agreements. Accordingly, our fees are fixed and determinable upon the execution of the agreement.

Provisions for doubtful accounts and transaction losses and authorized credits are made at the time of revenue recognition based upon our historical experience. The provision for doubtful accounts and transaction losses are recorded as charges to operating expense, while the provision for authorized credits is recognized as a reduction of net revenues.

Taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer may be presented on either a gross basis (included in revenues and costs) or on a net basis (excluded from revenues). The Company presents these taxes on a net basis in its financial statements.

Our payment processing revenues are derived from one-time set-up fees, monthly gateway fees, and transaction fees paid to us by merchants. Transaction fees are recognized in the period in which the transaction occurs. Gateway fees are

Table of Contents

monthly subscription fees charged to our merchant customers for the use of our payment processor integrations and are recognized in the period in which the service is provided. Set-up fees represent one-time charges for initiating our processing services. Although these fees are generally paid at the commencement of the agreement, they are recognized ratably over the estimated average life of the merchant relationship.

Restricted Cash

Restricted cash consists of cash and cash equivalents that are held in escrow accounts or restricted by agreements with third parties for a particular purpose. Restricted cash and cash equivalents are included in current assets under Prepaid expenses and other on our Consolidated Balance Sheets, and are recorded at fair value. As of June 30, 2013 and December 31, 2012, we had $2.6 million and $0.4 million of restricted cash, respectively.

Prepaid Expenses and Other

Prepaid expenses and other are largely comprised of prepaid expenses, restricted cash, inventory, other current assets and value added tax assets. In the second quarter of 2012, $0.6 million was lent through a short-term promissory note to another company and recorded on the Prepaid expenses and other line of the Consolidated Balance Sheets. During the third quarter of 2012, collection of the note was deemed unlikely and a $0.6 million reserve was recorded against the note.

Software Development

Costs to develop software for internal use are required to be capitalized and amortized over the estimated useful life of the software. For the three months ended June 30, 2013 and 2012, we capitalized $0.5 million and $1.5 million related to software development, respectively. For the six months ended June 30, 2013 and 2012, we capitalized $1.0 million and $2.8 million related to software development, respectively. This capitalization is primarily related to the development of our new commerce functionality and platform enhancements.

Goodwill

We complete our goodwill impairment analysis on an annual basis or more frequently if events or circumstances occur that would more likely than not reduce the fair value of the reporting unit below its carrying amount. As we only have one operating segment, goodwill is evaluated based on a single reporting unit. In December 2012, due to the deterioration in our stock price in the second half of 2012, adjustments in our forecasted revenue growth and change in our chief operating decision maker, management completed an interim impairment test and determined that the book value of the Company was in excess of fair value and a goodwill impairment was required. In the fourth quarter 2012, we recorded a non-cash pretax goodwill impairment charge of $175.2 million, or $161.1 million after tax, relating to our single reporting unit. The impairment charge was an estimate pending final valuation of a privately held equity security in calculating the goodwill impairment charge of $175.2 million.

During the first quarter of 2013, we determined the fair market value of the privately held equity security, which we had estimated at year end, and completed our goodwill impairment analysis. As a result of our analysis we recorded an additional non-cash pretax goodwill impairment charge of $21.2 million relating to our single reporting unit. These goodwill charges are included as a separate operating expense line item, Goodwill impairment in our Consolidated Statements of Operations. The tax benefit was offset by our current period tax valuation allowance. A blended income and market approach was used to determine the fair value of our sole reporting unit and associated impairment charges. The application of goodwill impairment tests requires management judgment for many of the inputs. Key assumptions included in the impairment test included our revenue growth rate, discount rate assumptions, and estimates of our future cash flows. Changes in these estimates could result in additional impairment of goodwill in a future period. The impairment charge reflects our view of anticipated risks based on our expectations of market and general economic conditions. See Note 5 Goodwill for further details.

Comprehensive Income (Loss)

Comprehensive income (loss) includes revenues, expenses, and gains and losses that are excluded from net earnings under GAAP. Items of comprehensive income (loss) are unrealized gains and losses on investments and foreign currency translation adjustments which are added to net income (loss) to compute comprehensive income (loss). Comprehensive income (loss) is net of income tax benefit or expense, excluding cumulative translation adjustments as these funds are indefinitely invested.

The following table summarizes the changes in accumulated other comprehensive income (loss), net of tax, by component for the period ended June 30, 2013 (in thousands):

Table of Contents

	Foreign currency translation adjustment	Unrealized gain (loss) on investments	Total
Balance as of December 31, 2012	$ 2,565	$ (5,735)	$ (3,170)
Other comprehensive income before reclassifications	(8,225)	2,040	(6,185)
Amount reclassified from accumulated other comprehensive income (loss)		4	4
Net current period other comprehensive income (loss)	(8,225)	2,044	(6,181)
Balance as of June 30, 2013	$ (5,660)	$ (3,691)	$ (9,351)

The following table summarizes the reclassifications out of accumulated other comprehensive income (loss), net of tax, for the six months ended June 30, 2013 (in thousands):

Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income	Affected line item in the Consolidated Statement of Operations
Realized gains (losses) on investments		
	$ 6	Other income (expense), net
	(2)	Income tax benefit (expense)
	$ 4	Net income (loss)

Foreign Currency Translation

Substantially all of our foreign subsidiaries use the local currency of their respective countries as their functional currency. Assets and liabilities are translated at exchange rates prevailing at the balance sheet dates. Revenues, costs and expenses are translated at the average exchange rates for the reported period. Gains and losses resulting from translation are recorded as a component of Accumulated other comprehensive income (loss) within stockholders equity. Gains and losses resulting from foreign currency transactions are recognized as Other income (expense), net .

We are exposed to market risk from changes in foreign currency exchange rates. Our primary risk is the effect of foreign currency exchange rate fluctuations on the U.S. dollar value of foreign currency denominated operating sales and expenses. We are also exposed to financial risk related to exchange rate translation losses (or gains) associated with economic interests that are denominated in a foreign currency. The risk of translation losses due to foreign exchange volatility is partially mitigated by the use of foreign exchange forward contracts with maturities of less than three months. These derivative transactions are not designated as hedges and are adjusted to fair value each period through Other income (expense), net in our Consolidated Statements of Operations. The principal exposures mitigated were euro, pound sterling, Danish krone, Swedish kronor, Brazilian real and Australian dollar currencies. For the three and six months ended June 30, 2013 and 2012, the gain/loss on derivative settlements was immaterial. The notional amounts held at period end and the underlying gain/loss were determined to be immaterial when compared to our overall cash and cash equivalents and the net income (loss) reported for the respective periods.

Our foreign currency contracts contain credit risk to the extent that our bank counterparties may be unable to meet the terms of the agreements. We minimize such risk by limiting our counterparties to major financial institutions of high credit quality.

Recent Accounting Pronouncements

ASU 2013-02 Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income: In February 2013, the FASB issued ASU 2013-02 which required entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, entities are required to present, either in the financial statements or footnotes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, entities are required to cross-reference to other disclosures required under U.S.

Table of Contents

GAAP that provide additional detail on these amounts. ASU 2013-02 is effective prospectively for fiscal periods beginning after December 15, 2012. We have adopted the new guidance in ASU 2013-02 as of the period ended March 31, 2013, and its adoption did not have a material impact on our Consolidated Financial Statements.

We have determined that all other recently issued accounting standards will not have a material impact on our Consolidated Financial Statements, or do not apply to our operations.

Reclassifications

Certain items in the prior year s Consolidated Statements of Operations have been reclassified for comparative purposes to conform to the current year presentation. Historically, we have reported payment processing fees, chargebacks, and directly related personnel expenses within the Sales and marketing and General and administrative line items. We have reclassified these expenses to the Direct cost of services line as these costs are associated directly with services rendered. For the three and six months ended June 30, 2012, we have reclassified $12.6 million and $26.9 million, respectively, previously reported as Sales and marketing and $0.4 million and $0.9 million, respectively, previously reported as General and administrative to Direct cost of services . The reclassifications did not have an effect on reported consolidated net income (loss).

2. NET INCOME (LOSS) PER SHARE

The following table summarizes the computation of basic and diluted net income (loss) per share (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Net income (loss) per share - basic				
Net income (loss) - basic	$ (872)	$ 200	$ (12,237)	$ 4,937
Weighted average shares outstanding - basic	32,478	33,453	32,816	33,629
Net income (loss) per share - basic	$ (0.03)	$ 0.01	$ (0.37)	$ 0.15
Net income (loss) per share - diluted				
Net income (loss) - basic	$ (872)	$ 200	$ (12,237)	$ 4,937
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit				
Net income (loss) - diluted	$ (872)	$ 200	$ (12,237)	$ 4,937
Weighted average shares outstanding - basic	32,478	33,453	32,816	33,629
Dilutive impact of non-vested stock and options outstanding		108		192
Dilutive impact of 2004 senior convertible notes				
Weighted average shares outstanding - diluted	32,478	33,561	32,816	33,821
Net income (loss) per share - diluted	$ (0.03)	$ 0.01	$ (0.37)	$ 0.15

For the three and six months ended June 30, 2013, 260,614 and 331,017, respectively, incremental shares, related to dilutive securities were not included in the diluted net income (loss) per share calculation because the Company reported a loss for both periods. Incremental shares related to dilutive securities have an anti-dilutive impact on net income (loss) per share when a net loss is reported and therefore are not included in the calculation.

Options to purchase 825,134 and 1,496,936 shares for the three months ended June 30, 2013 and 2012, respectively, and 825,134 and 1,496,936 shares for the six months ended June 30, 2013 and 2012, respectively, were not included in the computation of diluted net income (loss) per share because their effect on diluted net income (loss) per share would have been anti-dilutive.

The unissued shares underlying our 2004 senior convertible notes, 199,828 weighted average shares for the three and six months ended June 30, 2013, were excluded for the purposes of calculating GAAP diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive. The unissued shares underlying our 2010 senior convertible notes, 6,076,419 and 7,022,027 weighted average shares for the three months ended June 30, 2013 and 2012, respectively, and 6,096,519 and 7,022,027 weighted average shares for the six months ended June 30, 2013 and 2012,

Table of Contents

respectively,were excluded for the purposes of calculating GAAP diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive.

3. FAIR VALUE MEASUREMENTS

Financial assets and liabilities that are remeasured and reported at fair value at each reporting period are classified and disclosed in one of the following three categories:

Level 1 Observable inputs such as quoted prices in active markets;

Level 2 Other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets in less active markets than Level 1 investments;
- Inputs other than quoted prices that are observable for assets or liabilities; and
- Inputs that are derived principally from or corroborated by other observable market data.

Level 3 Unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management s estimate of market participant assumptions.

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis

The fair value hierarchy requires the use of observable market data when available. In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Our assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability. The Company s policy is to recognize transfers between levels at the end of the quarter.

The following table sets forth by level within the fair value hierarchy, our financial assets that were accounted for at fair value on a recurring basis at June 30, 2013 and December 31, 2012, (in thousands), according to the valuation techniques we used to determine their fair values.

There have been no transfers of assets between the fair value hierarchies presented below:

	Fair Value Measurements			
	Total	Level 1	Level 2	Level 3
Balance as of June 30, 2013				
Cash and cash equivalents	$ 422,847	$ 422,847	$	$
Restricted cash	2,637	2,637		
Commercial paper	2,654	2,654		
U.S. government sponsored entities	11,978		11,978	
Corporate bonds	132,299	132,299		
Asset-backed securities	420		420	
Market basis equity investments	1,949	1,949		
Auction rate securities	40,146			40,146
Total assets measured at fair value	$ 614,930	$ 562,386	$ 12,398	$ 40,146
Balance as of December 31, 2012				
Cash and cash equivalents	$ 542,851	$ 542,851	$	$
Restricted cash	351	351		
U.S. government sponsored entities	28,110		28,110	
Corporate bonds	128,622	128,622		
Asset-backed securities	6,062		6,062	
Market basis equity investments	1,694	1,694		
Auction rate securities	37,001			37,001
Total assets measured at fair value	$ 744,691	$ 673,518	$ 34,172	$ 37,001

Table of Contents

The following table is a reconciliation of assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3 inputs) (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Short-term Investments	Long-term Investments	Total
Balance as of December 31, 2011	$	$ 65,338	$ 65,338
Total unrealized gains (losses) included in other comprehensive income		(2,637)	(2,637)
Purchases			
Issuances			
Settlements		(25,700)	(25,700)
Transfers in and/or out of Level 3			
Balance as of December 31, 2012	$	$ 37,001	$ 37,001
Total unrealized gains (losses) included in other comprehensive income		3,245	3,245
Purchases			
Issuances			
Settlements		(100)	(100)
Transfers in and/or out of Level 3			
Balance as of June 30, 2013	$	$ 40,146	$ 40,146

The following methods and assumptions were used to estimate the fair value of each class of financial instrument. There have been no changes in the valuation techniques used by the Company to fair value our financial instruments:

Cash and Cash equivalents. Consist of cash on hand in bank deposits, highly liquid investments, primarily high grade commercial paper and money market accounts, all with original maturities of three months or less. The fair value was measured using quoted market prices and is classified as Level 1. The carrying amount approximates fair value.

Restricted Cash. Consists of cash and cash equivalents that are held in escrow accounts or restricted by agreements with third parties for a particular purpose. The carrying amount approximates fair value and is classified as Level 1.

Commercial Paper. Consist of primarily high grade commercial paper. The fair value of these investments was measured using quoted market prices and is classified as Level 1. The contractual maturity of these investments is within one year.

U.S government sponsored entities. Consist of Fannie Mae, Freddie Mac and Federal Home Loan Bank investment grade bonds that are traded in less active markets than Level 1 investments. The fair value of these bonds is classified as Level 2. The contractual maturity of these investments is within one year.

Corporate Bonds. Consist of investment grade corporate bonds that trade with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The fair value of these bonds was measured using quoted market prices and is classified as Level 1. The contractual maturity of these investments is within three years.

Asset Backed Securities. Consist of securities backed by automobile loan receivables that are traded in less active markets than our Level 1 investments. The fair value is classified as Level 2. The contractual maturity of these investments is within one year.

Market Basis Equity Investments. Consist of available-for-sale equity securities that trade with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The fair value of these investments was measured using quoted market prices and is classified as Level 1.

Auction Rate Securities. As of June 30, 2013, we held $45.7 million of auction rate securities (ARS) at par value which we have recorded at fair value of $40.1 million. As of December 31, 2012, we held $45.8 million of ARS at par value

Table of Contents

which was recorded at fair value of $37.0 million. The ARS are 105 134% over-collateralized and the underlying student loans are guaranteed by the U.S. government. Almost all of these securities continue to fail at auction due to continued illiquid market conditions.

Due to the illiquid market conditions, we recorded a temporary fair value reduction of our ARS in the amount of $5.6 million (12.2% of par value) as of June 30, 2013, under Accumulated other comprehensive income (loss) , compared to a $8.8 million temporary fair value reduction as of December 31, 2012 (19.3% of par value). In evaluating our ARS portfolio, we note sustained performance of our securities, strong parity levels, observed market redemption activity, and continued receipt of interest and penalty payments. As we expect to receive all contractual cash flows, we do not believe the unrealized losses to be credit related. We continue to believe that we will be able to liquidate at par over time. We do not intend to sell the investments prior to recovery of their amortized cost basis nor do we believe it is more likely than not we may be required to sell the investments prior to recovery of their amortized cost basis. Accordingly, we treated the fair value decline as temporary. We anticipate we will have sufficient cash flow from operations to execute our business strategy and fund our operational needs. We believe that capital markets are also available if we need to finance other investment alternatives.

The discounted cash flow model we used to value these securities included the following assumptions:

	June 30, 2013	**December 31, 2012**
Unobservable inputs		
Redemption period (in years)	7.0	7.0
Credit ratings	BB+ to AAA	BB+ to AAA
Penalty coupon rate	1.0% to 1.5%	1.0% to 1.5%
Weighted average annualized yield	1.5%	1.5%
Risk adjusted discount rate	4.4% to 10.2%	3.5% to 12.3%

Management makes estimates and assumptions about the ARS, which can be sensitive to changes and effect the determination of fair value. An increase in the length of redemption period or an increase in the discount rate assumption would decrease our fair value. Also, a decrease in the securities credit ratings would decrease our fair value.

The portfolio had a weighted average maturity of 30.3 years and 30.8 years as of June 30, 2013 and December 31, 2012, respectively.

We classify our ARS as Level 3 long-term investments until we receive a call or partial call on the securities. Upon receipt of a call or partial call, we classify the securities subject to the call or partial call, as Level 1 short term investments. As of June 30, 2013 and December 31, 2012, our entire ARS portfolio was classified as Level 3 long-term investments. In the six months ended June 30, 2013, we liquidated $0.1 million of ARS due to partial calls at par. During the year ended December 31, 2012, we liquidated $25.7 million of ARS due to full calls, partial calls or sales at par. The amount of Level 3 assets as a percentage of total assets measured at fair value on a recurring basis was 6.5% and 5.0% as of June 30, 2013 and December 31, 2012, respectively.

Assets and Liabilities that are Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, they are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances including evidence of impairment. For the six months ended June 30, 2013, other than the impairment disclosed in Note 5 Goodwill, we had no significant fair value adjustments of assets or liabilities on a nonrecurring basis subsequent to their initial recognition. The inputs used in the goodwill impairment fair value calculations fall within Level 3 inputs due to the significant unobservable inputs used to determine the fair value.

4. INVESTMENTS

As of June 30, 2013 and December 31, 2012, our available-for-sale securities consisted of the following (in thousands):

Table of Contents

			Gross Unrealized Losses			Maturities/Reset Dates	
	Cost	Gross Unrealized Gains	Less than 12 Months	Greater than 12 Months	Fair Value	Less than 12 Months	Greater than 12 Months
Balance as of June 30, 2013							
Commercial paper	$ 2,654	$	$	$	$ 2,654	$ 2,654	$
U.S. government sponsored entities	12,002	1	(25)		11,978	11,978	
Corporate bonds	132,091	331	(123)		132,299	71,938	60,361
Asset-backed securities	420				420	420	
Market basis equity investments	1,949				1,949		1,949
Auction rate securities	45,725			(5,579)	40,146		40,146
Total available-for-sale securities	$ 194,841	$ 332	$ (148)	$ (5,579)	$ 189,446	$ 86,990	$ 102,456
Balance as of December 31, 2012							
U.S. government sponsored entities	$ 28,103	$ 7	$	$	$ 28,110	$ 28,110	$
Corporate bonds	128,035	587			128,622	51,094	77,528
Asset-backed securities	6,058	4			6,062	6,062	
Market basis equity investments	1,694				1,694		1,694
Auction rate securities	45,825			(8,824)	37,001		37,001
Total available-for-sale securities	$ 209,715	$ 598	$	$ (8,824)	$ 201,489	$ 85,266	$ 116,223

We consider the fair value decline of our investments in U.S. government sponsored entities, corporate bonds and auction rate securities to be temporary, as we do not intend to sell the investments and it is not likely that we will be required to sell the investments before recovery of their amortized cost basis. See Note 3 Fair Value Measurements, regarding the fair value decline in auction rate securities.

Realized gains or losses on investments are recorded in our Consolidated Statements of Operations within Other income (expense), net . As of June 30, 2013 and December 31, 2012, our proceeds on sales of investments equaled par value. Upon the sale of a security classified as available for sale, the amount reclassified out of Accumulated other comprehensive income (loss) into earnings is based on the specific identification method.

As of June 30, 2013 and December 31, 2012, our cost method equity investments were $10.5 million and $33.0 million, respectively, and are included under Long-term investments on the Consolidated Balance Sheets. During the first quarter of 2013, we sold a cost method equity investment to a third party and recorded a gain of $11.1 million. During the second quarter of 2013, we received additional funds based on our sales agreement and as a result we recorded a gain of $6.5 million on the line item Other income (expense), net in our Consolidated Statements of Operations. Based on future events, we may receive up to $3.1 million of additional sale proceeds. We have concluded that these additional funds represent contingent gains and have not accounted for them in our consolidated financial statements in accordance with U.S. GAAP. We have evaluated our cost method equity investments for impairment as of June 30, 2013 and we are not aware of any facts or circumstances that would indicate a decline in the fair value of these investments below their carrying value.

5. GOODWILL

Goodwill

We complete our goodwill impairment analysis on an annual basis or more frequently if events or circumstances occur that would more likely than not reduce the fair value of the reporting unit below its carrying amount. As we only have one operating segment, goodwill is evaluated based on a single reporting unit. In December 2012, due to the deterioration in our stock price in the second half of 2012, adjustments in our forecasted revenue growth and change in our chief operating decision maker, management completed an interim impairment test and determined that the book value of the Company was in excess of fair value and a goodwill impairment was required. In the fourth quarter 2012, we recorded a non-cash pretax goodwill impairment charge of $175.2 million, or $161.1 million after tax, relating to our single reporting unit. The impairment charge was an estimate pending final valuation of a privately held equity security in calculating the goodwill impairment charge of $175.2 million.

During the first quarter of 2013, we determined the fair market value of the privately held equity security, which we had estimated at year end, and completed our goodwill impairment analysis. As a result of our analysis we recorded an additional non-cash pretax goodwill impairment charge of $21.2 million relating to our single reporting unit. These goodwill charges are included as a separate operating expense line item, Goodwill impairment in our Consolidated Statements of Operations. The tax benefit was offset by our current period tax valuation allowance. A blended income and market approach was used to determine the fair value of our sole reporting unit and associated impairment charges. The application of goodwill impairment tests requires management judgment for many of the inputs. Key assumptions included in the impairment test included our revenue growth rate, discount rate assumptions, and estimates of our future cash flows. Changes in these estimates could result in additional

Table of Contents

impairment of goodwill in a future period. The impairment charge reflects our view of anticipated risks based on our expectations of market and general economic conditions.

The changes in the net carrying amount of goodwill for the periods ended June 30, 2013 and December 31, 2012 are as follows (in thousands):

	Goodwill	Accumulated Impairment Total	Total
Balance as of December 31, 2011	$ 281,858	$	$ 281,858
Disposal of goodwill	(254)		(254)
Impairment losses		(175,241)	(175,241)
Adjustments from foreign currency translation	2,597		2,597
Balance as of December 31, 2012	$ 284,201	$ (175,241)	$ 108,960
Goodwill from acquisitions	54,319		54,319
Impairment losses		(21,249)	(21,249)
Adjustments from foreign currency translation	(3,723)		(3,723)
Balance as of June 30, 2013	$ 334,797	$ (196,490)	$ 138,307

Goodwill from acquisitions for the six months ended June 30, 2013 is related to the acquisition of LML Payment Systems, Inc. (LML). Factors that contributed to the recognition of goodwill from the LML acquisition include synergies due to an assembled workforce and existence of complimentary business models which can be leveraged to build an enterprise of greater value than the sum of its parts. In accordance with ASC 350, this goodwill will be tested for impairment annually or more frequently if certain indicators of impairment are present. See Note 10 Business Combinations for further details regarding the LML acquisition.

6. STOCK-BASED COMPENSATION

The following table summarizes stock-based compensation expense related to employee stock options, restricted stock awards and employee stock purchases recognized (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Costs and expenses				
Direct cost of services	$ 47	$ 58	$ 89	$ 118
Network and infrastructure	327	368	742	732
Sales and marketing	1,799	2,129	3,631	4,297
Product research and development	846	953	1,771	1,688
General and administrative	3,360	2,723	5,721	5,357
Stock-based compensation included in costs and expenses	$ 6,379	$ 6,231	$ 11,954	$ 12,192

7. INCOME TAXES

The provision (benefit) for income taxes is composed of the following (in thousands):

Table of Contents

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Current tax expense (benefit):				
United States	$ (102)	$ 1,471	$ 1,436	$ 1,349
International	(756)	(909)	(1,373)	253
Total current provision for income taxes	$ (858)	$ 562	$ 63	$ 1,602
Tax Rate	49.6%	73.8%	(0.5)%	24.5%

As of June 30, 2013, we had U.S. federal tax loss carryforwards of approximately $26.7 million and state tax loss carryforwards of $44.3 million to offset future taxable income. The tax losses consist of U.S. federal net operating losses of $16.9 million and acquired U.S. federal net operating losses of $9.8 million as well as state net operating losses of $42.0 million and acquired state net operating losses of $2.3 million. The U.S. federal tax loss carryforwards expire in the years 2025 through 2032, while the state tax loss carryforwards expire in the years 2014 through 2032. As of June 30, 2013, we also had foreign tax loss carryforwards of approximately $9.0 million. The foreign tax loss carryforwards do not expire under current law.

On a quarterly basis, we assess whether a valuation allowance for net operating loss carryforwards and other deferred tax assets is needed. Based on accounting guidance, we concluded during the 2013 second quarter s evaluation that the accounting rules require us to maintain a valuation allowance against our net U.S. tax assets. At June 30, 2013, the Company had a valuation allowance on approximately $11.3 million of U.S. deferred tax assets related to operating losses and $31.3 million of deferred tax assets related to other U.S. tax attributes. We also have a valuation allowance on all of our foreign net operating losses of approximately $2.3 million. Any future release of this valuation allowance will reduce expense.

As of June 30, 2013, we had $12.1 million of unrecognized tax benefits, including related interest. All of these unrecognized tax benefits would affect our effective tax rate if recognized. As of June 30, 2013, we had approximately $1.5 million of accrued interest related to uncertain tax positions. Due to the potential resolution of examinations currently being performed by taxing authorities and the expiration of various statutes of limitation, it is reasonably possible that the balance of our gross unrecognized tax benefits may change within the next twelve months by a range of zero to $2.5 million.

8. COMMITMENTS AND CONTINGENCIES

Litigation

DDR Holdings, LLC (DDR Holdings) brought a claim against us and several other defendants regarding U.S. Patents Nos. 6,629,135 (the 135 patent), 6,993,572 (the 572 patent), and 7,818,399 (the 399 Patent), which are owned by DDR Holdings. These patents claim e-commerce outsourcing systems and methods relating to the provision of outsourced e-commerce support pages having a common look and feel with a host s website. The case was filed in the U.S. District Court for the Eastern District of Texas on January 31, 2006 seeking injunctive relief, declaratory relief, damages and attorneys fees. We denied infringement of any valid claim of the patents-in-suit, and asserted counter-claims seeking a judicial declaration that the patents are invalid and not infringed. After a delay due to DDR Holdings request for re-examination of the 135 and 572 patents, in October 2010 the Court granted DDR Holdings unopposed motion to lift the stay in the litigation. Digital River and DDR concluded discovery and pre-trial depositions in August 2012. In pre-trial motions, DDR dropped its claims against Digital River with respect to the 135 and 399 patent. On October 12, 2012, the jury found in favor of the plaintiff on the infringement claim in connection with the 572 patent and awarded damages of $0.8 million (versus plaintiff s demand of $10.2 million). On June 20, 2013, the court denied Digital River s post-trial motions and entered judgment in the amount of $1.1 million (which amount includes pre-judgment interest), plus costs and post-judgment interest. Digital River has filed its notice of appeal. During the third quarter of 2012, initial full settlement of the awarded damages (exclusive of interest which may be awarded by the court) was accrued for on the Other accrued liabilities line of the Consolidated Balance Sheets and the General and administrative line of the Consolidated Statements of Operations. The accrued amount was adjusted to $1.1 million during the second quarter of 2013 to reflect the award of pre-judgment interest.

In December 2010, a lawsuit was filed against a number of software companies, including us, by Uniloc USA, Inc. and Uniloc Singapore Private Limited in the United States District Court for the Eastern District of Texas. The complaint seeks monetary damages in unspecified amounts and permanent injunction based upon claims for alleged patent infringement. We are at an early stage of this matter. While we intend to vigorously defend this matter, we cannot predict the timing or ultimate outcome, nor estimate a range of loss, if any, for this matter.

Table of Contents

We are subject to legal proceedings, claims and litigation arising in the ordinary course of business. While the final outcome of these matters is currently not determinable, we believe there is no ordinary course litigation pending against us that is likely to have, individually or in the aggregate, a material effect on our consolidated financial position, results of operation, stockholders equity or cash flows. Because of the uncertainty inherent in litigation, it is possible that unfavorable resolutions of these lawsuits, proceedings and claims could exceed the amount we have currently reserved for these matters.

From time to time, we are involved in other disputes or regulatory inquiries that arise in the ordinary course of business. Any claims or regulatory actions against us, whether meritorious or not, could be time consuming, result in costly litigation, damage awards, injunctive relief or increased costs of doing business through adverse judgment or settlement, require us to change our business practices in expensive ways, require significant amounts of management time, result in the diversion of significant operational resources or otherwise harm our business. These matters are subject to inherent uncertainties and management s view of these matters may change in the future.

Third parties have from time-to-time claimed, and others may claim in the future, that we have infringed their intellectual property rights. We have been notified of several potential patent disputes, and expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity. We have in the past been forced to litigate such claims. We may also become more vulnerable to third-party claims as laws, such as those related to privacy and online commerce the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are enacted by legislatures and interpreted by the courts, and as we expand geographically into jurisdictions where the underlying laws with respect to the potential liability of online intermediaries like ourselves are either unclear or less favorable. These claims, whether meritorious or not, could be time consuming and costly to resolve, cause service upgrade delays, require expensive changes in our methods of doing business, or could require us to pay damages or enter into costly royalty or licensing agreements.

Indemnification Provisions

In the ordinary course of business we have included limited indemnification provisions in certain of our agreements with parties with whom we have commercial relations. Under these contracts, we generally indemnify, hold harmless and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with claims by any third party with respect to our domain names, trademarks, logos and other branding elements to the extent that such marks are applicable to our performance under the subject agreement. In certain agreements, including both agreements under which we have developed technology for certain commercial parties and agreements with our clients, we have provided an indemnity for other types of third-party claims. To date, no significant costs have been incurred, either individually or collectively, in connection with our indemnification provisions.

In addition, we are required by our credit card processors to comply with credit card association operating rules, and we have agreed to indemnify our processors for any fines they are assessed by credit card associations as a result of processing payments for us. The credit card associations and their member banks set and interpret the credit card rules. Visa, MasterCard, American Express or Discover could adopt new operating rules or re-interpret existing rules that we or our credit card processors might find difficult to follow. We also could be subject to fines or increased fees from MasterCard and Visa.

Commitments and Guarantees

At certain times, we enter into agreements where a letter of credit is required to ensure payment of future obligations by counterparties, such as our credit card processors and international taxing jurisdictions. Upon withdrawal, we are obligated to fund the executor bank on demand. We have not set aside specific funds to cover this potential obligation as we can generally recover these costs from our clients. If drawn upon, we expect to fund this commitment with cash and cash equivalents. There were $0.5 million and $3.6 million in undrawn letters of credit as of June 30, 2013 and December 31, 2012, respectively.

9. DEBT

2010 Senior Convertible Notes

On November 1, 2010, we sold and issued $345.0 million in aggregate principal amount of senior convertible notes (2010 Notes), in a private, unregistered offering. The 2010 Notes are unsecured obligations and rank equally with all of our existing and future senior unsecured debt. The 2010 Notes were sold at their total principal amount. The 2010 Notes bear interest at the rate of 2.00% per annum from the date of issuance, payable semi-annually on May 1 and November 1, commencing on May 1, 2011. The 2010 Notes will mature, unless earlier repurchased, redeemed or converted in accordance

Table of Contents

with their terms, on November 1, 2030.

We began repurchasing our 2010 senior convertible notes in the open market in the fourth quarter of 2012. For the three and six months ended June 30, 2013, we repurchased $4.0 million and $5.4 million, respectively, of the 2010 Notes in the open market at an average price of 99.1% of par and 98.8% of par, respectively. For the three and six months ended June 30, 2013, the net gain on extinguishment of debt was immaterial, which is the net of the gain on sale offset by the write-off of debt issuance costs. As of December 31, 2012, we repurchased $43.9 million of the 2010 Notes in the open market at an average price of 98.5% of par. Notes repurchased are deemed to be extinguished for accounting purposes.

Holders have the right to convert some or all of the 2010 Notes at any time prior to the maturity date into shares of our common stock at the initial conversion rate of 20.3537 shares per $1,000 in principal amount of the 2010 Notes, which is equal to an initial conversion price of approximately $49.13 per share. At the initial conversion rate, assuming the conversion of all $295.8 million in aggregate principal amount, the 2010 Notes may be converted into approximately 6,019,607 shares of our common stock. We will adjust the conversion price if certain events occur, as specified in the related indenture, such as the issuance of our common stock as a dividend or distribution or the occurrence of a stock subdivision or combination. If we undergo certain types of fundamental changes, as defined in the indenture, on or before November 1, 2015, we will be required to pay a fundamental change make-whole premium on 2010 Notes converted in connection with such make-whole fundamental change by increasing the conversion rate. The amount of the fundamental change make-whole premium, if any, will be based on our common stock price and the effective date of the make-whole fundamental change.

At any time on or after November 1, 2015, and prior to the maturity date, we may redeem for cash some or all of the 2010 Notes at a redemption price equal to the principal amount of the 2010 Notes to be redeemed, plus accrued and unpaid interest to, but excluding, the redemption date.

Holders have the right to require us to repurchase some or all of their 2010 Notes for cash on each of November 1, 2015, November 1, 2020 and November 1, 2025, at a repurchase price equal to the principal amount of the 2010 Notes to be repurchased, plus accrued and unpaid interest to, but excluding, the relevant repurchase date. If we undergo certain types of fundamental changes prior to the maturity date, holders of the 2010 Notes will have the right, at their option, to require us to repurchase some or all of their 2010 Notes at a repurchase price equal to the principal amount of the 2010 Notes being repurchased, plus accrued and unpaid interest to, but excluding, the repurchase date.

As of June 30, 2013, the fair value of our $295.8 million 2010 senior convertible notes was valued at $294.8 million based on the quoted fair market value of the debt. As of December 31, 2012, the fair value of our $301.1 million 2010 senior convertible notes was valued at $285.3 million based on the quoted fair market value of the debt. Debt is classified as a level 3 fair value measurement. We determine fair value based on the market approach.

2004 Senior Convertible Notes

In 2004, we sold and issued $195.0 million in aggregate principal amount of 1.25% senior convertible notes due January 1, 2024 (2004 Notes), in a private, unregistered offering. The 2004 Notes were sold at their principal amount. On January 5, 2009, we announced that the majority of the holders of the 2004 Notes exercised the option to require us to repurchase those Notes on January 2, 2009. Notes with an aggregate principal amount of approximately $8.8 million remain outstanding. Holders of the remaining outstanding 2004 Notes have the right to require us to repurchase their 2004 Notes prior to maturity on January 1, 2014 and 2019.

We are required to pay interest on the 2004 Notes on January 1 and July 1 of each year so long as the 2004 Notes are outstanding. The 2004 Notes bear interest at a rate of 1.25% and, if specified conditions are met, are convertible into our common stock at a conversion price of $44.063 per share. At the initial conversion rate, assuming the conversion of our $8.8 million in remaining principal debt, the 2004 Notes may be converted into approximately 199,828 shares of our common stock. The 2004 Notes may be surrendered for conversion under certain circumstances, including the satisfaction of a market price condition, such that the price of our common stock reaches a specified threshold; the satisfaction of a trading price condition, such that the trading price of the 2004 Notes falls below a specified level; the redemption of the 2004 Notes by us, the occurrence of specified corporate transactions, as defined in the related indenture; and the occurrence of a fundamental change, as defined in the related indenture. The initial conversion price is equivalent to a conversion rate of approximately 22.6948 shares per $1,000 of principal amount of the 2004 Notes. We will adjust the conversion price if certain events occur, as specified in the related indenture, such as the issuance of our common stock as a dividend or distribution or the occurrence of a stock subdivision or combination.

As of June 30, 2013 and December 31, 2012, the fair value of our $8.8 million 1.25% 2004 senior convertible notes

Table of Contents

was valued at $8.7 million and $8.6 million, respectively, based on the quoted fair market value of the debt. Debt is classified as a level 3 fair value measurement. We determine fair value based on the market approach.

10. BUSINESS COMBINATIONS

On January 10, 2013 we acquired 100% of the capital stock of LML Payment Systems, Inc., a publically held payment service provider with operations in Victoria, British Columbia in an all cash transaction valued at $3.45 per share, or an aggregate purchase price of approximately $102.8 million. Acquisition and integration costs of $0.3 million and $4.8 million were expensed as incurred, and were recorded in the line item General and administrative on our Consolidated Statements of Operations for the three and six months ended June 30, 2013, respectively. LML is a leading provider of payment processing services to the Canadian small and medium sized business market. This acquisition was made to broaden our online payments services to businesses of all sizes. The goodwill arising from the transaction consists primarily of synergies due the existence of an assembled workforce and synergies expected to be gained when combining the complimentary Digital River and LML business models. None of the goodwill recognized is expected to be deductible for income tax purposes.

For the three months ended June 30, 2013, LML revenue was $6.5 million and net income was $0.9 million. LML revenue for the period starting as of the acquisition date of January 10, 2013, and ending on June 30, 2013, was $12.1 million. LML net income for the period starting as of the acquisition date of January 10, 2013, and ending on June 30, 2013, was $0.6 million.

The preliminary allocation of the purchase price for the LML acquisition has been assigned to assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The fair value of assets acquired and liabilities assumed was based upon a preliminary valuation and our estimates and assumptions are subject to change within the measurement period. During the three months ended June 30, 2013, the acquisition date fair value of intangible assets was increased $2.6 million, which resulted in a corresponding increase in deferred tax liabilities of $0.6 million and a decrease in residual goodwill of $2.0 million. The primary areas of the purchase price that are not yet finalized as of June 30, 2013 are related to accounts receivable, other assets, intangibles, income taxes, deferred tax accounts, other liabilities and residual goodwill.

The preliminary allocation of the purchase price is summarized in the following table (in thousands):

		LML Payment Systems, Inc.
Cash and cash equivalents	$	46,957
Accounts receivable		1,366
Receivable of acquisition expenses incurred on behalf of Digital River		1,068
Customer and partner relationships		23,230
Trade names		3,567
Other intangibles		1,185
Goodwill		54,319
Other assets		4,841
Total assets acquired		136,533
Other liabilities		33,733
Total liabilities assumed		33,733

Total allocation of purchase price consideration		102,800
Less: cash acquired		(46,957)
Total purchase price, net of cash acquired	$	55,843

For the LML acquisition, customer and partner relationships have a weighted average useful life of 5.0 years, trade names have a weighted average useful life of 5.0 years and other intangibles have a weighted average useful life of 4.8 years.

Information regarding our intangible assets acquired from the LML acquisition is as follows (in thousands):

Table of Contents

	As of June 30, 2013		
	Carrying Amount Gross	Accumulated Amortization	Carrying Amount Net
Customer and partner relationships	$ 23,230	$ 2,220	$ 21,010
Trade names	3,567	341	3,226
Other intangibles	1,185	134	1,051
Total	$ 27,982	$ 2,695	$ 25,287

Amortization expense of LML acquisition-related intangible assets was $1.6 million and $2.7 million for the three and six months ended June 30, 2013 respectively.

Estimated amortization expense for the remaining life of the LML intangible assets, based on intangible assets as of June 30, 2013, is as follows (in thousands):

Year	
Remainder of 2013	$ 2,835
2014	5,613
2015	5,613
2016	5,613
2017	5,613
Total	$ 25,287

Pro Forma Operating Results (Unaudited)

The unaudited pro forma financial information in the table below summarizes the combined results of operations for Digital River, Inc. and LML. The consolidated financial statements include the historical operating results of each business acquired from the date of acquisition.

The historical financial information has been adjusted to give effect to pro forma events that are directly attributable to the transaction, are factually supportable and, in the case of the pro forma results of operations, have a nonrecurring impact. For the three and six months ended June 30, 2013, the pro forma results include adjustments primarily related to amortization of acquired intangible assets of $1.5 million and $2.8 million, respectively, less elimination of LML historical intangible amortization expense of $0.2 million and $0.3 million, respectively, and income taxes benefit of $0.3 million and $0.6 million, respectively. The following unaudited pro forma condensed results of operations for three and six months ended June 30, 2013, have been prepared as if the LML acquisition had occurred on January 1, 2012, (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenue	$ 93,393	$ 96,387	$ 207,086	$ 209,402
Net income (loss)	(580)	(483)	(11,945)	5,621

This pro forma financial information does not purport to represent results that would actually have been obtained if the transactions had been in effect on January 1, 2012, as applicable, or any future results that may be realized.

All other business combination activities have been determined to be immaterial when compared to our consolidated financial statements.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The discussion in this Quarterly Report contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed below. Additional factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section entitled Risk Factors, included in Item 1A of Part II of this Quarterly Report. When used in this document, the words believes, expects, anticipates, intends, plans, and similar expressions, are intended to identify certain of these forward-looking statements. However, these words are not the exclusive means of identifying such statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. The cautionary statements made in this document should be read as being applicable to all related forward-looking statements wherever they appear in this document. We have no obligation to update the matters set forth herein, whether as a result of new information, future events or otherwise.

Business Overview

We provide end-to-end global cloud-commerce, payments and marketing solutions to a wide variety of companies in software, consumer electronics, computer games, video games and other markets. We offer our clients a broad range of services that enable them to quickly and cost effectively establish an online sales channel capability and to subsequently manage and grow online sales on a global basis while mitigating risks. Our services include design, development and hosting of online stores and shopping carts, store merchandising and optimization, order management, denied parties screening, export controls and management, tax compliance and management, fraud management, digital product delivery via download, physical product fulfillment, subscription management, online marketing including e-mail marketing, management of affiliate programs, paid search programs, payment processing services, website optimization, web analytics and reporting, and CD production and delivery.

Our products and services allow our clients to focus on promoting and marketing their products and brands worldwide while leveraging our investments in technology and infrastructure to facilitate the purchase of products through their online websites. When shoppers visit one of our clients branded websites they are transferred to an online commerce store and/or shopping cart operated by us on our commerce platforms. Once on our system, shoppers can browse for products and make purchases online. We typically are the seller of record for transactions through our client branded stores. After a purchase is made, we either deliver the product digitally via download over the Internet or transmit instructions to a third party for physical fulfillment of the order. We also typically process the buyer s payment as the merchant of record, including collection and remittance of applicable taxes and compliance with various regulatory matters. We have invested substantial resources to develop our cloud-commerce and marketing platforms, including direct-to-buyer software, and we provide access and use of our platforms to our clients as a service as opposed to selling the software to be operated on their own in-house computer hardware. Our cloud-commerce store solutions range from simple remote control models to more comprehensive online store models.

In addition to the services we provide that facilitate the completion of an online transaction, we also offer services designed to increase traffic to our clients websites and the associated online stores and to improve the sales productivity of those stores. Our services include paid search advertising, search engine optimization, affiliate marketing, store optimization, multi-variant testing, web analytic services and e-mail optimization. All of our services are designed to help our clients acquire customers more effectively, sell to those customers more often and more efficiently, and increase the lifetime value of each customer.

Additionally, through our Digital River World Payments subsidiary, we offer a full range of payment processing services to clients. These services from our subsidiary in conjunction with our purchase of LML, include multiple payment methods, fraud management, tax management, cloud-based billing and other payment optimization services.

Current Period Results and Outlook

For the three months ended June 30, 2013, we recorded a net loss of $0.9 million or ($0.03) per share compared to net income of $0.2 million or $0.01 per diluted share for the same period in the prior year. Revenues of $92.5 million for the three months ended June 30, 2013, represent a 1.9% increase versus the same period in the prior year as additional revenue from our LML acquisition offsets lower non-commerce and support business revenue and the continuing impact of client attrition on commerce revenue. The level of client attrition and its impact on revenue was consistent with our expectations and previous communications.

Total costs and expenses for the three months ended June 30, 2013, of $99.1 million increased 10.4% compared to the same period in the prior year. As of June 30, 2013 and December 31, 2012, we had $570.2 million and $705.6 million in cash, cash equivalents and short-term investments, respectively.

Our management s discussion and analysis includes the quarterly results of LML s earnings starting as of the acquisition date of January 10, 2013.

Table of Contents

We continue to be in the early stages of a strategic transformation. We are making substantial investments, up to $22 million in 2013, with continuing investments into 2014, to deliver a more flexible commerce ecosystem, pursue high-impact growth markets, as well as create financial capacity that will drive growth and improved operating margins over time.

Other

On May 8, 2012, we entered into with Microsoft Corporation (Microsoft   ), in the ordinary course of business, the Third Omnibus Amendment to the Microsoft Operations Digital Distribution Agreement (the   Third Omnibus Amendment   ). The Third Omnibus Amendment extends the term of Microsoft Operations Digital Distribution Agreement to a date no earlier than March 1, 2014. Additionally, the Third Omnibus Amendment allowed for the expansion of the business relationship pursuant to which we have and continue to build, host and manage the Microsoft Store, an e-commerce store that supports the sale and fulfillment of Microsoft and third party software as well as consumer electronics products, to customers throughout the world. In addition, pursuant to the Third Omnibus Amendment, we continue to act as a reseller of Microsoft products.

We view our operations and manage our business as one reportable segment, providing outsourced commerce solutions globally to a variety of companies, primarily in the software and consumer electronics product markets.

We were incorporated in Delaware in February 1994. Our headquarters are located at 10380 Bren Road West, Minnetonka, Minnesota and our telephone number is 952-253-1234.

General information about us can be found at www.digitalriver.com under the   Company/Investor Relations   link or follow the Company on Twitter at twitter.com/digitalriverinc. Our annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as well as any amendments or exhibits to those reports, are available free of charge through our website as soon as reasonably practicable after we file such reports with the Securities and Exchange Commission.

Results of Operations

LML Acquisition

On January 10, 2013 we acquired all of the capital stock of LML Payment Systems, Inc., a publically held payment service provider with operations in Victoria, British Columbia in an all cash transaction valued at $3.45 per share, or an aggregate purchase price of approximately $102.8 million. The inclusion of LML   s financial results since the acquisition date represent an increase to our operations in the six months ended June 30, 2013 when compared to the same period in the prior year.

Reclassifications

Certain items in the prior year s Consolidated Statements of Operations have been reclassified for comparative purposes to conform to the current year presentation. Historically, we have reported payment processing fees, chargebacks, and directly related personnel expenses within the Sales and marketing and General and administrative line items. We have reclassified these expenses to the Direct cost of services line as these costs are associated directly with services rendered. For the three and six months ended June 30, 2012, we have reclassified $12.6 million and $26.9 million, respectively, previously reported as Sales and marketing and $0.4 million and $0.9 million, respectively, previously reported as General and administrative to Direct cost of services . The reclassifications did not have an effect on reported consolidated net income (loss).

The following table sets forth certain items from our Consolidated Statements of Operations as a percentage of total revenue for the periods indicated:

Table of Contents

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenue	100.0%	100.0%	100.0%	100.0%
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	19.0	17.8	19.7	17.9
Network and infrastructure	15.7	14.2	14.4	13.3
Sales and marketing	29.4	30.0	28.2	28.9
Product research and development	19.6	17.0	17.4	16.2
General and administrative	15.5	12.6	16.0	12.2
Goodwill impairment			10.3	
Depreciation and amortization	5.5	5.5	4.9	5.3
Amortization of acquisition-related intangibles	2.5	1.9	1.9	1.9
Total costs and expenses	107.2	98.9	112.8	95.8
Income (loss) from operations	(7.2)	1.1	(12.8)	4.2
Interest income	0.8	1.1	0.7	1.1
Interest expense	(2.1)	(2.5)	(1.9)	(2.3)
Other income (expense), net	6.6	1.1	8.3	0.4
Income (loss) before income taxes	(1.9)	0.8	(5.9)	3.4
Income tax expense (benefit)	(0.9)	0.6		0.8
Net income (loss)	(0.9)%	0.2%	(5.9)%	2.6%

Revenue. Our revenue was $92.5 million for the three months ended June 30, 2013, compared to $90.8 million for the same period in the prior year, an increase of $1.7 million or 1.9%. For the six months ended June 30, 2013, revenue totaled $206.2 million, an increase of $13.0 million, or 6.7%, from revenue of $193.2 million for the same period in the prior year.

Our commerce revenues are driven primarily by global commerce and payment services provided to a wide variety of companies in the software, consumer electronics, computer games and other markets. Commerce revenues include revenues generated from Microsoft. All other non-commerce revenues are driven primarily by our e-mail and affiliate marketing businesses.

For the three months ended June 30, 2013, the $1.7 million increase in revenue was driven primarily by an increase in commerce revenue of $6.5 million related to LML. This increase was partially offset by a decrease of $0.2 million in our commerce business and a decrease of $4.6 million in our non-commerce and support business revenue. For the six months ended June 30, 2013, the $13.0 million increase in revenue was driven primarily by increases in commerce revenue of $12.1 million from LML and $9.5 million from launches of new client products. These increases were partially offset by a decrease in our non-commerce and support business revenue of $8.6 million. LML revenue for the period starting as of the acquisition date of January 10, 2013, and ending on June 30, 2013, was $12.1 million.

International sales were approximately 49.3% and 48.1% of total sales in the three and six month periods ended June 30, 2013, compared to 46.7% and 46.7% for the same periods in the prior year.

Direct Cost of Services. Direct cost of services includes payment processing fees, chargeback expense, fraud detection and prevention, costs related to product fulfillment, backup CD production, delivery solutions and certain client-specific costs. Direct cost of service were $17.6 million for the three months ended June 30, 2013, compared to $16.1 million for the same period in the prior year. Direct cost of service expenses were $40.5 million for the six months ended June 30, 2013, compared to $34.5 million for the same period in the prior year. The increase in direct cost of services is primarily related to higher revenue in the first six months of 2013 compared to the same period in the prior year.

Network and Infrastructure. Our network and infrastructure expenses primarily include costs to operate and maintain our technology platforms, customer service, data communication and data center operations. Network and infrastructure expenses were $14.5 million and $12.9 million for the three months ended June 30, 2013 and 2012, respectively. Network and infrastructure expenses were $29.8 million and $25.7 million for the six months ended June 30, 2013 and 2012, respectively. The increase was mainly due to higher data communication and IT related costs related to enhancing our flexibility and stability within our commerce environments.

Table of Contents

Sales and Marketing. Our sales and marketing expenses include personnel and related costs, advertising, promotional and product marketing expenses, and bad debt expense. Sales and marketing expenses were flat year over year in the second quarter; $27.2 million and $27.2 million for the three months ended June 30, 2013 and 2012, respectively. Sales and marketing expenses were $58.1 million and $55.9 million for the six months ended June 30, 2013 and 2012, respectively. The increase year-to-date was driven by additional first quarter 2013 expenses primarily related to corporate website redesign and branding initiatives as well as the addition of LML expenses.

Product Research and Development. Our product research and development expenses include costs associated with design, development and enhancement of our technology platforms and related systems. Research and development costs are expensed as incurred, except certain internal-use software development costs eligible for capitalization and costs directly associated with preparing a client website launch eligible to be deferred and amortized over the life of the sites associated revenue streams. These costs drive enhanced technologies and strengthen our leadership position in the markets we serve. These investments advance our global system scalability, e-marketing capabilities, data management and client reporting. Product research and development expenses were $18.2 million and $15.4 million for the three months ended June 30, 2013 and 2012, respectively. Product research and development expenses were $36.0 million and $31.4 million for the six months ended June 30, 2013 and 2012, respectively. The increase was primarily due to increased emphasis in our investment in platform stability.

General and Administrative. Our general and administrative expenses primarily include executive, finance, human resources and other administrative workforce and other related expenses, fees for professional services, bank fees, litigation costs, insurance costs, integration costs and non-income related taxes. General and administrative expenses were $14.3 million and $11.4 million for the three months ended June 30, 2013 and 2012, respectively. General and administrative expenses were $32.9 million and $23.6 million for the six months ended June 30, 2013 and 2012, respectively. The increase in the first quarter of 2013 was primarily related to severance, legal fees, and acquisition and integration costs associated with LML. The increase in the second quarter of 2013 was primarily related to strategic consulting expenses associated with business process transformation plans.

Goodwill Impairment. In December 2012, due to the deterioration in our stock price in the second half of 2012, adjustments in our forecasted revenue growth and change in our chief operating decision maker, management completed an interim impairment test and determined that the book value of the Company was in excess of fair value and a goodwill impairment was required. In the fourth quarter 2012, we recorded a non-cash pretax goodwill impairment charge of $175.2 million, or $161.1 million after tax, relating to our single reporting unit. The impairment charge was an estimate pending final valuation of a privately held equity security in calculating the goodwill impairment charge of $175.2 million. During the first quarter of 2013, we determined the fair market value of the privately held equity security which we had estimated at year end and completed our goodwill impairment analysis, recording an additional non-cash pretax goodwill impairment charge of $21.2 million, relating to our single reporting unit.

Depreciation and Amortization. Our depreciation and amortization expenses include the depreciation of computer equipment, office furniture, leasehold improvements, and the amortization of purchased and internally developed software. Computer equipment, software and furniture are depreciated under the straight-line method using three to seven year lives and leasehold improvements are amortized over the shorter of the life of the asset or the remaining length of the lease. Depreciation and amortization expense was $5.1 million and $5.0 million for the three months ended June 30, 2013 and 2012, respectively. Depreciation and amortization expense was $10.1 million and $10.3 million for the six months ended June 30, 2013 and 2012, respectively.

Amortization of Acquisition-Related Intangibles. Amortization of acquisition-related intangibles consists of the amortization of intangible assets such as customer and partner relationships, technology and trade names acquired in business combinations. Amortization of acquisition-related intangible assets was $2.3 million and $1.7 million for the three months ended June 30, 2013 and 2012, respectively. Amortization of acquisition-related intangible assets was $4.2 million and $3.6 million for the six months ended June 30, 2013 and 2012, respectively. The increase was driven primarily by the addition of intangibles associated with the purchase of LML.

Interest Income. Our interest income represents the total of interest income on our cash, cash equivalents, short-term investments and certain long-term investments. Interest income was $0.8 million and $1.0 million for the three months ended June 30, 2013 and 2012, respectively. Interest income was $1.4 million and $2.1 million for the six months ended June 30, 2013 and 2012, respectively. The decrease in interest income was due to less cash and cash equivalents and short-term investments related to the acquisition of LML and stock and debt repurchases completed during the first half of 2013 and the fourth quarter of 2012.

Table of Contents

Interest Expense. Our interest expense includes the total of cash and non-cash interest expense attributable to our outstanding convertible debt. For the three months ended June 30, 2013 and 2012, interest expense was $2.0 million and $2.3 million, respectively, which included $0.4 million and $0.5 million of debt financing cost amortization, respectively. For the six months ended June 30, 2013 and 2012, interest expense was $4.0 million and $4.5 million, respectively, which included $0.9 million and $1.0 million of debt financing cost amortization, respectively. The decrease in interest expense was due to the repurchase of our senior convertible notes during the first half of 2013 and the fourth quarter of 2012, which bear an annual interest rate of 2.0%.

Other Income (Expense), Net. Our other income (expense), net includes foreign currency transaction gains and losses, gains and losses on investments or asset disposals, other-than-temporary impairment of investments and dividend income. Other income (expense), net was $6.1 million and $1.0 million for the three months ended June 30, 2013 and 2012, respectively. For the three months ended June 30, 2013, the increase is primarily driven by the receipt of additional funds under the sales agreement related to the first quarter sale of one of our cost method investments, which resulted in a gain of $6.5 million, offset by unfavorable foreign currency re-measurement losses during the quarter. Other income (expense), net was $17.0 million and $0.7 million for the six months ended June 30, 2013 and 2012, respectively. For the six months ended June 30, 2013, the increase is primarily driven by the sale of a cost method equity investment to a third party which resulted in a gain of $17.6 million, offset by unfavorable foreign currency re-measurement losses during the quarter.

Income Tax Expense. For the three months ended June 30, 2013 and 2012, our tax benefit was $0.9 million and our tax expense was $0.6 million, respectively. For the three months ended June 30, 2013, our tax benefit consisted of approximately $0.1 million of U.S. tax benefit and $0.8 million of foreign tax benefit. For the three months ended June 30, 2012, our tax expense consisted of approximately $1.5 million of U.S. tax expense and $0.9 million of foreign tax benefit. For the three months ended June 30, 2013 and 2012, the tax rate was 49.6% and 73.8%, respectively. The difference in tax rates is due to different discrete items occurring in the quarters as well as the valuation allowance established in the fourth quarter of 2012.

Off Balance Sheet Arrangements

None.

Table of Contents

Liquidity and Capital Resources

Cash Flows (in thousands)	Six Months Ended June 30, 2013		2012	
Cash provided by (used in):				
Operating activities	$	(63,931)	$	(51,847)
Investing activities		(15,770)		1,749
Financing activities		(38,397)		(20,860)
Effect of exchange rate changes on cash and cash equivalents		(1,906)		(4,693)
Net increase (decrease) in cash and cash equivalents	$	(120,004)	$	(75,651)

Operating Activities

As of June 30, 2013, we had $422.8 million of cash and cash equivalents, approximately 49.4% of which are held by our international subsidiaries. If funds held by our international subsidiaries were repatriated to the U.S. we would incur a U.S. tax liability that is not currently accrued in our financial statements. However, cash and cash equivalents held in the U.S. are sufficient to fund our current and anticipated domestic operations. As a result, we do not anticipate any local liquidity restrictions that would preclude us from funding our expansion or operating needs and do not foresee a need to repatriate any earnings.

As of June 30, 2013 and December 31, 2012, we had $570.2 million and $705.6 million in cash, cash equivalents and short-term investments, respectively. Excluding client payables and client receivables, we had $481.6 million and $550.4 million in net short-term liquidity as of the end of June 30, 2013 and December 31, 2012, respectively. Our company cash, which includes cash and non-equity investments and excludes client payables and client receivables, was $521.7 million and $587.4 million as of June 30, 2013, and December 31, 2012, respectively.

Net cash used in operations for the six months ended June 30, 2013, of $63.9 million was primarily the result of our net loss, adjusted for non-cash expenses and income from gain on sale of an equity investment, and changes in working capital. Net cash used in operations for the six months ended June 30, 2012, of $51.8 million was primarily the result of changes in working capital, offset by net income, adjusted for non-cash expenses.

Investing Activities

Net cash used in investing activities for the six months ended June 30, 2013, was $15.8 million and was the result of net cash paid for acquisitions of $55.8 million, net sales of investments of $53.2 million and purchases of equipment and capitalized software of $13.2 million. Net cash provided by investing activities for the six months ended June 30, 2012, was $1.7 million and was the result of net sales of investments of $7.9 million and purchases of equipment and capitalized software of $6.2 million.

Financing Activities

Net cash used in financing activities for the six months ended June 30, 2013, was $38.4 million. This was primarily driven by $31.2 million cash used in the repurchase of common stock, $4.3 million cash used in the repurchase of restricted stock to satisfy tax withholding obligations, and repurchase of convertible senior notes of $5.4 million, offset by proceeds of $1.3 million provided by the exercise of stock options. Net cash used in financing activities for the six months ended June 30, 2012, was $20.9 million. This was primarily driven by $20.2 million cash used in the repurchase of common stock, and $3.5 million cash used in the repurchase of restricted stock to satisfy tax withholding obligations, offset by proceeds of $1.5 million provided by the exercise of stock options.

Effect of Exchange Rate Changes

For the three months ended June 30, 2013, changes in foreign currency rates resulted in a $1.9 million decrease in our cash and cash equivalents. The change is due to foreign currency volatility on our international entity balance sheet exposures, primarily from the euro.

Table of Contents

Auction Rate Securities

As of June 30, 2013, we held $45.7 million of auction rate securities (ARS) at par value which we have recorded at $40.1 million fair value. As of December 31, 2012, we held $45.8 million of ARS at par value which was recorded at $37.0 million fair value. The ARS are 105 134% over-collateralized and the underlying student loans are guaranteed by the U.S. government. Almost all of these securities continue to fail at auction due to continued illiquid market conditions.

Due to the illiquid market conditions, we recorded a temporary fair value reduction of our ARS in the amount of $5.6 million (12.2% of par value) as of June 30, 2013, under Accumulated other comprehensive income (loss) , compared to a $8.8 million temporary fair value reduction as of December 31, 2012 (19.3% of par value). In evaluating our ARS portfolio, we note sustained performance of our securities, strong parity levels, observed market redemption activity, and continued receipt of interest and penalty payments. As we expect to receive all contractual cash flows, we do not believe the unrealized losses to be credit related. We continue to believe that we will be able to liquidate at par over time. We do not intend to sell the investments prior to recovery of their amortized cost basis nor do we believe it is more likely than not we may be required to sell the investments prior to recovery of their amortized cost basis. Accordingly, we treated the fair value decline as temporary. We anticipate we will have sufficient cash flow from operations to execute our business strategy and fund our operational needs. We believe that capital markets are also available if we need to finance other investment alternatives.

The discounted cash flow model we used to value these securities included the following assumptions:

	June 30, 2013	**December 31, 2012**
Unobservable inputs		
Redemption period (in years)	7.0	7.0
Credit ratings	BB+ to AAA	BB+ to AAA
Penalty coupon rate	1.0% to 1.5%	1.0% to 1.5%
Weighted average annualized yield	1.5%	1.5%
Risk adjusted discount rate	4.4% to 10.2%	3.5% to 12.3%

Management makes estimates and assumptions about the ARS, which can be sensitive to changes and effect the determination of fair value. An increase in the length of redemption period or an increase in the discount rate assumption would decrease our fair value. Also, a decrease in the securities credit ratings would decrease our fair value.

The portfolio had a weighted average maturity of 30.3 years and 30.8 years as of June 30, 2013 and December 31, 2012, respectively.

We classify our ARS as Level 3 long-term investments until we receive a call or partial call on the securities. Upon receipt of a call or partial call, we classify the securities subject to the call or partial call, as Level 1 short term investments. As of June 30, 2013 and December 31, 2012, our entire ARS portfolio was classified as Level 3 long-term investments. In the six months ended June 30, 2013, we liquidated $0.1 million of ARS due to partial calls at par. During the year ended December 31, 2012, we liquidated $25.7 million of ARS due to full calls, partial calls or sales at par. The amount of Level 3 assets as a percentage of total assets measured at fair value on a recurring basis was 6.5% and 5.0% as of June 30, 2013 and December 31, 2012, respectively.

Commitments and Guarantees

At certain times, we enter into agreements where a letter of credit is required to ensure payment of future obligations by counterparties, such as our credit card processors and international taxing jurisdictions. Upon withdrawal, we are obligated to fund the executor bank on demand. We have not set aside specific funds to cover this potential obligation as we can generally recover these costs from our clients. If drawn upon, we expect to fund this commitment with cash and cash equivalents. There were $0.5 million and $3.6 million in undrawn letters of credit at June 30, 2013 and December 31, 2012, respectively.

Table of Contents

Application of Critical Accounting Policies

Critical Accounting Estimates and Policies

A detailed description of our significant accounting policies can be found in our most recent Annual Report filed on Form 10-K for the fiscal year ended December 31, 2012. There was no material changes in significant accounting policies during the quarter ended June 30, 2013.

Recent Accounting Pronouncements

Information regarding recently issued accounting standards is included in Note 1 to the Consolidated Financial Statements.

Item 3. Qualitative and Quantitative Disclosure about Market Risk

Interest Rate Risk

Our portfolio of cash equivalents, short-term and long-term investments is maintained in a variety of securities, including government agency obligations and money market funds. Investments are classified as available-for-sale securities and carried at their market value with cumulative unrealized gains or losses recorded as a component of Accumulated other comprehensive income (loss) within stockholders equity. A sharp rise in interest rates could have an adverse impact on the market value of certain securities in our portfolio. We do not currently hedge our interest rate exposure and do not purchase financial instruments for trading or speculative purposes.

At June 30, 2013, we had long-term debt of $304.6 million associated with our Senior Convertible Notes, which are fixed rate instruments. The market value of our long-term debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest and declining in periods of increasing rates of interest.

Foreign Currency Risk

Growth in our international operations will incrementally increase our exposure to foreign currency fluctuations as well as other risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures and other regulations and restrictions.

Foreign exchange rate fluctuations may adversely impact our consolidated results of operations as exchange rate fluctuations on transactions denominated in currencies other than our functional currencies result in gains and losses that are reflected in our Consolidated Statements of Operations. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency-denominated transactions will result in increased net revenues and operating expenses. Conversely, our net revenues and operating expenses will decrease when the U.S. dollar strengthens against foreign currencies.

Transaction Exposure

The Company enters into short-term foreign currency forward contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain assets and liabilities recorded in non-functional currencies. Changes in the fair value of these derivatives, as well as re-measurement gains and losses, are recognized in current earnings in   Other income (expense), net . Foreign currency transaction gains and losses were a loss of $0.4 million and a gain $0.1 million in the three months ended June 30, 2013 and 2012, respectively. Foreign currency transaction losses were $0.5 million and $0.2 million in the six months ended June 30, 2013 and 2012, respectively.

Translation Exposure

Foreign exchange rate fluctuations may adversely impact our consolidated financial position as the assets and liabilities of our foreign operations are translated into U.S. dollars in preparing our Consolidated Balance Sheets. These gains or losses are recognized as an adjustment to stockholders   equity which is reflected in our Consolidated Balance Sheets under   Accumulated other comprehensive income (loss) .

Other Market Risks

Investments in Auction Rate Securities

At June 30, 2013, we held approximately $45.7 million of ARS at par. In light of current conditions in the ARS market as described in Item 2,   Management   s Discussion and Analysis of Financial Condition and Results of Operations , in this Quarterly Report on Form 10-Q, we may incur temporary unrealized losses, or other-than-temporary realized losses, in the future if we are unable to recover the investment principal in our ARS.

Table of Contents

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We are committed to maintaining disclosure controls and procedures designed to ensure that information required to be disclosed in our periodic reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a 15(e) and 15d-15(e) under the Exchange Act) as of June 30, 2013. The term disclosure controls and procedures means controls and other procedures that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that such information is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on their evaluation of our disclosure controls and procedures as of June 30, 2013, our Chief Executive Officer and our Chief Financial Officer concluded that as of that date, our disclosure controls were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

Except as set forth below, there were no changes in the Company s internal control over financial reporting (as defined in Rule 13a 15(f) and 15d 15(f) under the Exchange Act) during the quarter ended June 30, 2013, that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

In connection with the acquisition of LML Payment Systems, Inc., management has elected to exclude LML from management s assessment of the effectiveness of our internal control over financial reporting for the year ended December 31, 2013, and the quarters therein, as permitted by the Securities and Exchange Commission. As of June 30, 2013, total assets attributable to LML, excluding $75.0 million of goodwill and intangible assets, represented approximately $25.5 million or 2.7% of our total assets. Total revenue attributable to LML represented approximately $6.5 million of net revenue, or 7.0% of net revenue for the three months ended June 30, 2013. Total revenue attributable to LML represented approximately $12.1 million of net revenue, or 5.9% of net revenue for the period starting as of the acquisition date of January 10, 2013, and ending on June 30, 2013.

Limitations on the Effectiveness of Controls

Our management, including the Chief Executive Officer and Chief Financial Officer, is responsible for establishing and maintaining an adequate system of internal control over financial reporting. This system of internal accounting controls is designed to provide reasonable assurance that assets are safeguarded, transactions are properly recorded and executed in accordance with management s authorization and financial statements are prepared in accordance with generally accepted accounting principles. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We have provided information about legal proceedings in which we are involved in Note 8 to the Consolidated Financial Statements in Part I, Item 1.

Item 1A. Risk Factors

The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we currently deem immaterial also may impair our business operations. Our business, financial condition or results of operations could be materially adversely affected by any of these risks and the value of our common stock could decline due to any of these risks, and you could lose all or part of the money you paid to buy our common stock. The following discussion of our risk factors should be read in conjunction with the consolidated financial statements and related notes thereto, and management s discussion and analysis, contained in this report, and the risk factors contained in our Annual Report on Form 10-K for the year ended December 31, 2012. Our business is also subject to general risks and uncertainties that affect many other companies. In addition, the current global economic climate amplifies many of these risks.

This report also contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks faced by us described below and elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2012.

Risks Related to Our Business

We may experience significant fluctuations in our revenues, operating results, growth rate and stock price.

Our quarterly and annual revenues, operating results, and growth rate have fluctuated significantly in the past and are likely to do so in the future due to a variety of factors, some of which are outside our control. As a result, we believe that quarter-to-quarter and year-to-year comparisons of our revenue and operating results are not necessarily meaningful, and that these comparisons may not be accurate indicators of future performance. If our annual or quarterly operating results fail to meet the guidance we provide to securities analysts and investors or otherwise fail to meet their expectations, the trading price of our common stock may be impacted.

Factors that may affect our revenues, operating results, continued growth, and our stock price include the risks described elsewhere in this section, as well as the following:

• *Client Development and Retention.* We generate revenue by providing services to a wide variety of companies, primarily in the software and high-tech products markets. Therefore, it is important to our ongoing success that we maintain our key client relationships and, at the same time, both develop new client relationships and increase the number and type of products offered through our services. If we cannot successfully market our products and services, develop and maintain satisfactory relationships with software and digital products publishers, manufacturers of consumer electronics and other goods, online retailers and online channel partners on acceptable commercial terms, or if clients elect to end their relationships with us and we are unable to generate sufficient additional revenue to compensate for the loss of those relationships, we will likely experience a decline in revenue and operating profit. New product verticals or market segments, and further penetration of existing product verticals and market segments, may require us to work with companies which have a limited operating history or greater risks than more established companies. This may result in the engagement with clients and offering of products which are subject to higher chargeback rates or legal exposure and may generally expose us to greater legal and/or business risk. We may not be able to fully anticipate, mitigate or control all such risks. In the event claims are brought against us in connection with products offered by clients, especially clients with a limited operating history, weak sales, or who are or may become insolvent or bankrupt, we may not be successful in seeking indemnification for such claims from such clients and may be ultimately responsible for such claims. In the event a client becomes insolvent or bankrupt, we may not be successful in obtaining and retaining all amounts owed to us by that client, and the client may cease offering products for sale through our commerce services resulting in a decline in revenue and operating profit.

• We also depend on our clients to create and support products that consumers will purchase. We generally purchase products for resale from consignment or from distributors at the time of the resale to the consumer, and do not maintain an inventory of products available for sale. If we are unable to obtain sufficient quantities of products for

Table of Contents

any reason, or if the quality of service provided by these publishers and manufacturers falls below a satisfactory level, we could also experience a decline in revenue, operating profit and consumer satisfaction, and our reputation could be harmed.

• Our contracts with our clients are generally one to two years in duration, with an automatic renewal provision for additional one-year periods, unless we are provided with a written notice before the end of the contract. Some of our contracts are for longer periods, but may provide for early termination upon certain notice. For example, our contract with Microsoft expires March 1, 2014, subject to certain extension rights exercisable by Microsoft. We have no material long-term or exclusive contracts or arrangements with any clients that guarantee the availability of products. Clients that currently supply products to us may not continue to do so, and we may be unable to establish new relationships with clients to supplement or replace existing relationships. Clients may elect to cease offering certain products through online commerce, or cease allowing us to resell certain of their products. A client who believes we have failed to deliver the contractually-required services and benefits could terminate their agreements and bring claims against us for substantial damages, these claims could exceed the level of any insurance coverage that may be available to us, and if successful could adversely affect our operating results and financial condition. If an existing significant customer elects to end their relationship with us or if our sales of a significant customer s products materially decreases, our revenue would decline and it may have a material adverse effect on our business, financial condition, results of operations, growth rate and stock price.

• In addition, a limited number of our other software, gaming and physical goods clients contribute a large portion of our annual revenue. If any one of these key contracts is not renewed or otherwise terminates, or if revenues from these clients decline for any other reason (such as competitive developments), our revenue would decline and our ability to sustain profitability would be impaired. For example, please see the risk factor below regarding the impact that may result from a termination of Microsoft s e-commerce agreement with us.

• *Dependence on Key Personnel and Employee Turnover.* Our future success significantly depends on our ability to continue to identify, attract, hire, train, retain and motivate highly skilled personnel, including the continued services and performance of our senior management. Competition for these personnel is intense, particularly in the Internet industry. Our performance also depends on our ability to retain and motivate our key technical and other employees who are skilled in maintaining our proprietary technology platforms and business offerings. The loss of the services of any of our executive officers or other key employees could harm our business if we are unable to effectively replace that officer or employee, or if that person should decide to join a competitor or otherwise directly or indirectly compete with us. Employee turnover may also increase in light of the risks, uncertainties, expenses, delays and difficulties associated with operating a business in a relatively rapidly changing industry and environment. Effective February 28, 2013, Digital River s board of directors appointed David C. Dobson as chief executive officer and elected him to the Board of Directors of the Company. Mr. Dobson, age 50, has been a self-employed business consultant and private investor since July 2012. He served as Executive Vice President and Group Executive, Customer Solutions Group for CA, Inc. (CA), a leading enterprise information technology management software and solutions company, from July 2010 to July 2012, where he was responsible for managing CA s broad portfolio of products and solutions for mainframe, distributed and cloud computing environments. Prior to joining CA, Mr. Dobson served as Executive Vice President and Chief Strategy and Innovation Officer of Pitney Bowes Inc. (Pitney Bowes), a manufacturer of software and hardware and a provider of services related to documents, packaging, mailing and shipping, where he was responsible for leading the development of the company s long-term strategy from June 2008 to July 2009. In addition, he also served as President of Pitney Bowes Management Services, Inc., a wholly owned subsidiary of Pitney Bowes Inc., from August 2009 to July 2010. Prior to joining Pitney Bowes, he was Chief Executive Officer of Corel Corporation, a computer software company specializing in graphics processing, from 2005 to 2008. Before joining Corel Corporation, Mr. Dobson spent 19 years at IBM, where he held a number of senior management positions.

• *Organizational Changes.* In order to remain competitive and to control our costs, we have implemented in the past, and may be required to implement in the future, organizational changes within our company, such as the consolidation of e-commerce platforms or offices, utilization of subcontractors or outsourcing relationships, reorganization of our business, and reductions in force. We may incur significant costs in order to implement organizational changes to achieve efficiencies in our cost structure in the long term. Failure to effectively manage our subcontractors and outsourcing relationships may harm our business. These organizational changes may impact our ability to execute our business plans and could affect our operating results.

- *Operating Expenses*. Our operating expenses are based on our expectations of future revenue. These expenses are relatively fixed in the short-term. If our revenue for a quarter falls below our expectations and we are unable to quickly reduce spending in response, our operating results for that quarter would be harmed.

Table of Contents

• *Infrastructure*. The *introduction* by us of new websites, web stores or services, new features and functionality, our utilization of new third-party Infrastructure-as-a-Service (IaaS), Platform-as-a-Service (PaaS), and Software-as-a-Service (SaaS) cloud computing services, and the continued upgrading, development and maintenance of our systems and infrastructure to meet emerging market needs, support 24x7 online commerce, leverage technical innovations, and remain competitive in our service and product offerings, may require a substantial investment of our resources and result in significant capital expenditures and operating costs and expose us to additional risk and legal liability despite efforts to control such risks and liabilities.

• *Fluctuations in Demand*. Our quarterly and annual operating results are subject to fluctuations in demand for the products or services offered by us or our clients, such as personal computer software and consumer electronics. In particular, sales of personal computer software represented a significant portion of our revenues in recent years, and continue to be very important to our business. The introduction of products and services competitive to those offered by our current clients may materially adversely affect our revenues. In addition, revenue generated by our software and digital commerce services is likely to fluctuate on a seasonal basis that is typical for the markets for our clients products, including the software publishing, consumer electronics, and computer and video games markets. Softening or weakening of traditionally high-volume periods, such as the holiday season, can materially adversely affect our revenues and operating results.

• *Changes in the E-commerce and Payments Industries*. The nature of our business and the e-commerce and payments industries in which we operate has undergone, and continues to undergo, rapid development and change. For example, new protocols or technologies and new rules and regulations applicable to our business and the e-commerce and payments industries can be introduced which could affect the ways in which e-commerce operates and products are sold online; online commerce and payments continues to experience a rapid shift towards mobile and multi-channel commerce and payments; the payments industry continues to experience growth in new technologies such as the introduction of mobile-based payment systems; and consumers may continue to shift from traditional computing platforms to mobile and tablet-based computing platforms. It may be difficult for us to predict or adjust our business in light of such developments. Thus, our chances of financial and operational success should be evaluated in light of the risks, uncertainties, expenses, delays and difficulties associated with operating a business in a relatively rapidly changing industry and environment. If we are unable to address these issues, we may not be financially or operationally successful.

• *Other Factors. Additional* industry risks that may affect our revenues, operating results, continued growth and our stock price include:

• Competitive developments, including the introduction of new products and services and the announcement of new client and strategic relationships by our competitors;

• Changes that affect our clients or the viability of their product lines, and client decisions to delay new product launches, invest in e-commerce initiatives, utilize the services of a competitor, or internalize their currently outsourced e-commerce operations;

• The cost of compliance with U.S. and foreign laws, rules and regulations relating to our business, including the potential effect of new laws, rules and regulations, or interpretations of existing laws, rules and regulations, that affect our business operations or otherwise restrict or affect online commerce and/or the Internet as a whole, as well as our compliance with the rules and policies of entities whose services are critical for our continued operations, such as banks and credit card associations;

- Our announcement of acquisitions, strategic partnerships, joint ventures or capital commitments or results of operations or other developments related to those acquisitions, and our ability to successfully integrate and manage acquired businesses, as well as similar announcements by our competitors;

- Required changes in generally accepted accounting principles and disclosures;

- Sales or other transactions involving our common stock or our convertible notes;

- General macroeconomic conditions, including severe downturns or recessions in the United States and elsewhere, global unrest, terrorist activities, adverse effects of the ongoing sovereign debt crisis in Europe, potential impact of automatic sequesters, spending reductions, tax increases, and other austerity measures

Table of Contents

in the United States, and particularly those economic conditions affecting the e-commerce and retailer industries and affecting demand for products and services; and

- Conditions or trends in the Internet and online commerce industries in the United States and around the world, including slower-than-anticipated growth of the online market as a vehicle for the purchase of software products, changes in consumer confidence in the safety and security of online commerce, and changes in the usage of the Internet and e-commerce.

The following risks may also have a material adverse impact on our business, financial condition, results of operations and stock price:

Our stock price is volatile.

The stock market as a whole and the trading prices of companies in the electronic commerce industry in particular, has been notably volatile. The operating results of companies in the electronic commerce industry have experienced significant quarter-to-quarter fluctuations. This broad market and industry volatility could significantly reduce the price of our common stock at any time, without regard to our own operating performance.

The market price for our common stock has varied between a high of $18.94 and a low of $12.80 in the six months ended June 30, 2013. This volatility may affect the price at which you could sell your common stock. Our stock price is likely to continue to be volatile and subject to significant price and volume fluctuations in response to market and other factors; variations in our quarterly operating results from our expectations or those of securities analysts or investors; downward revisions in estimates by us or security analysts; and announcement by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments.

In addition, the price of our common stock may be impacted by the short sales and actions of other parties who may disseminate misleading information about us in an effort to profit from fluctuations in the price of our common stock. Further, the price of our common stock may be impacted by the announcement of the financial results or other decisions by our larger clients whose products represent a significant portion of our sales.

A material decline in the price of our common stock may result in the assertion of certain claims against us, and/or the commencement of inquiries and/or investigations against us. A prolonged decline in the price of our common stock could result in:

- A reduction in the liquidity of our common stock and a reduction in our ability to raise capital and the inability for you to obtain a favorable selling price for your shares;

- An event or circumstance that drives us to determine that it is more likely than not that the fair value of our one reporting segment is less than its carrying amount and record an impairment to our goodwill.

Any reduction in our ability to raise equity capital in the future may force us to reallocate funds from other planned uses and could have a significant negative effect on our business plans and operations.

The termination of our e-commerce agreement with Microsoft may materially adversely affect our business, financial condition or results of operations and stock price.

Sales of products for one client, Microsoft, accounted for a significant portion of our revenue in the three and six months ended June 30, 2013. In addition, a limited number of other software, gaming and physical goods clients contribute a large portion of our annual revenue. If any one of these key contracts is not renewed or otherwise terminates, or if revenues from these clients decline for any other reason (such as competitive developments), our revenue would decline and our ability to sustain profitability would be impaired. Our contract with Microsoft expires March 1, 2014, subject to certain extension rights exercisable by Microsoft. If our contract with Microsoft is not renewed, renegotiated or otherwise extended, or if revenues from Microsoft decline for any other reason, our revenue and our ability to sustain profitability could be materially adversely impaired.

Loss of our credit card acceptance privileges, or changes to the fees, rules or practices of payment and card associations, networks and banks, would seriously hamper our ability to process the sale of merchandise and materially adversely affect our business.

The payment by consumers for the purchase of goods and services through our e-commerce systems is typically made by credit or debit card or similar payment method across many countries. As a result, we must rely on domestic and international banks and payment processors to process transactions, and must pay a fee for this service. From time to time, banks and credit card associations may increase the per-transaction fees that they charge or change surcharge or comparable rules. In addition, reductions in the volume of transactions processed by us may result in increased per-transaction processing fees. Any such increased fees will increase our operating costs and reduce our profit margins. We also are required by our processors to comply with credit card association operating rules, and we have agreed to reimburse our processors for any fines they are assessed by credit card associations as a result of processing payments for us. The credit card associations and their member banks set and interpret the credit card rules. Visa, MasterCard, American Express, Discover and other card associations whose cards we accept could adopt new operating rules or re-interpret existing rules that we, or our processors, might find difficult to follow.

Although we have been able to successfully switch to new payment processors in the past, such migrations require significant attention from our personnel, and may not achieve the anticipated cost savings or other desired results. Any disputes or problems associated with our payment processors could impair our ability to give customers the option of using credit or debit cards to fund their payments. If we were unable to accept credit or debit cards or other widely accepted forms of payment, our business would be seriously damaged. Any change to our business practices due to the adoption of card association operating rules or the re-interpretation of existing rules that reduces the attractiveness of our services to our clients or restricts our ability to offer our services may materially adversely affect our revenues and operating results. While we do screen new merchants and monitor their site activities for export and sanctions compliance, we also could be subject to fines or increased fees from Visa and MasterCard if we fail to detect that our clients are engaging in activities that are illegal or activities that are considered high risk, primarily the sale of certain types of digital content, or if the percentage of our sales transactions subject to chargeback increases as an absolute percentage of our overall transaction volume. We may be required to expend significant capital and other resources to monitor these activities.

If our payments-related services are found to be in violation of, or subject to, applicable laws, rules or regulations or bank or card network rules or operating procedures, we may become subject to liability, licensing requirements, and regulatory approval, and may be required to change our business practices.

Our business is subject to various laws, rules and regulations in the U.S. and other countries where we provide payments-related services, including those laws, rules and regulations governing money transmission, export and sanctions compliance, electronic funds transfers, terrorist financing, money laundering, and consumer protection. The legal and regulatory requirements that apply to our business vary in the markets in which we operate. For our payment service provider business, we may be required to perform know-your-customer and other underwriting responsibilities, and may be subject to fines, penalties, financial reserves, or other enforcement actions from banks and payment card networks if we fail to detect improper use of our payment systems by our clients. While we have a compliance program focused on compliance with applicable laws, rules and regulations, we cannot ensure that we will not become subject to fines, penalties or other enforcement actions in one or more jurisdictions, or be required to make changes to our business practices or compliance programs to comply in the future. If we were found to be in violation of laws, rules or regulations, or bank or card network rules or operating procedures, we could become subject to liability and/or additional restrictions, forced to cease doing business or restrict the payment types we can offer in certain states or jurisdictions, forced to change business practices, or required to obtain additional licenses or regulatory approvals that could impose a substantial cost on us. We may not be able to pass such liabilities, fines and penalties to our clients or bank partners. Any change to our business practices that reduces the attractiveness of our services to our clients or restricts our ability to offer our services may materially adversely affect the revenues and operating results for our business.

Our business is subject to online security risks, including security breaches.

Our business depends in large part on the secure transmission of confidential information over public networks, including customers credit card and other payment account information, and the secure storage of confidential information. We rely on encryption and authentication technology licensed from third parties to provide the security and authentication necessary for secure transmission of confidential information, such as customer credit and debit card numbers. While we take significant steps to protect the security of confidential information in our possession, we cannot guarantee our security measures will prevent security breaches, or that future advances in computer and software capabilities and encryption technology, new cryptography tools and discoveries, and other events will enable us to prevent the breach or compromise of our security even if implemented by us. Further, the technology utilized in credit and debit cards, and the systems used for the transmission of payment card transactions, are controlled by the payment card industry, and vulnerabilities in these systems and technology can place payment card data at risk. Our servers are vulnerable to computer viruses, physical or electronic break-ins, denial of service attacks, and similar disruptions. Because techniques used to disable or impair systems, obtain unauthorized access to systems, or engage in other breaches of security change rapidly and are often not recognized until utilized against a target, we may be unable to anticipate these techniques or prevent them.

Any actual or perceived breach or compromise of our security or one of our clients, vendors or service providers could have a material adverse effect on consumer confidence in the safety and security of transactions processed through our

Table of Contents

systems, our reputation, business operations, operating results and financial condition, dissuade existing and new clients from using our services, dissuade customers from transacting business through our systems, and expose us to significant costs, fines, losses, litigation, governmental investigations and liabilities. A party who circumvents our security measures or the security measures of our clients, vendors or service providers could misappropriate proprietary information or interrupt our operations. We may be required to expend significant capital and other resources to protect against security breaches or address problems caused by such breaches. Security breaches could expose us to lawsuits from affected persons and companies, and to governmental inquiries. Concerns over the security of the Internet and other online transactions and the privacy of users could deter people from using the Internet to conduct transactions that involve transmitting personally identifiable and other confidential information, inhibiting the growth of our business.

We are exposed to foreign currency exchange risk.

As we generate a significant portion of our revenues outside the U.S. but report our financial results in U.S. dollars, we are exposed to adverse movements in currency exchange rates. Sales outside the United States accounted for approximately 49.3% of our total sales in the second quarter of 2013. A significant portion of our cash and marketable securities are held in non-U.S domiciled countries, primarily Ireland and Germany. The results of operations of, and certain of our intercompany balances associated with, our internationally focused websites are exposed to foreign exchange rate fluctuations. Upon translation, net sales and other operating results from our international operations may differ materially from expectations, and we may record significant gains or losses on the re-measurement of intercompany balances. If the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions will result in increased net revenues and operating expenses. Similarly, our net revenues and operating expenses will decrease if the U.S. dollar strengthens against foreign currencies, for example, as a result of the ongoing sovereign debt crisis in Europe. As we have expanded our international operations, our exposure to exchange rate fluctuations has become more pronounced. We may enter into short-term currency forward contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain assets and liabilities recorded in non-functional currencies. The use of such hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movements in foreign exchange rates.

Failure to enhance and expand our technology, systems and business offerings to accommodate increased traffic and to remain competitive could reduce demand for our services and impair the growth of our business.

We periodically enhance and expand our technology and transaction-processing systems, network infrastructure and other technologies to accommodate increases and spikes in the volume of traffic on our technology platforms due to factors including launches of new products and new commerce websites on our technology platforms, and seasonal fluctuations in consumer demand. To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our e-commerce platforms and the underlying network infrastructure, and develop and introduce new business offerings and programs. Any inability to enhance and expand our existing technology, transaction-processing systems or network infrastructure to manage such increased traffic and traffic spikes may cause unanticipated system disruptions, slower response times and degradation in client services, including impaired quality and speed of order fulfillment. Failure to manage increased traffic and traffic spikes or an inability to maintain our competitiveness could harm our reputation and significantly reduce demand for our services, which would impair the growth of our business. We may be unable to prevent unanticipated system disruptions due to the failure of network or hardware components in our underlying network infrastructure, such as the service disruption we suffered in February 2012 due to a hard drive disk array failure. If we incur significant costs without adequate results, or are unable to adapt rapidly to technological changes, we may fail to achieve our business plan. We may be unable to improve and increase the capacity of our network infrastructure sufficiently or to anticipate and react to expected or unexpected increases in the use of the platform to handle increased volume, or to obtain needed related services from third party suppliers. Our network and our suppliers   networks may be unable to maintain an acceptable data transmission capability, especially if demands on our platform increase. We may fail to use new technologies effectively or fail to adapt our proprietary technology and systems to client requirements or emerging industry standards.

We rely upon cloud-based service providers and other third party subcontractors in connection with our business operations, and any disruption of or interference with our use of the services provided by these providers would impact our operations and materially adversely affect our business.

We utilize, and may increase our utilization of, third-party Infrastructure-as-a-Service (IaaS), Platform-as-a-Service (PaaS), and Software-as-a-Service (SaaS) offerings, commonly referred to as cloud computing services. We also utilize third parties to support other aspects of our business operations, such as bandwidth providers, data center services, and fulfillment providers. While we seek to implement contractual obligations and indemnities in our agreements with our global cloud providers and other third party providers, we may not be successful in obtaining contractual terms sufficient to mitigate all risks. Problems faced by our third-party cloud computing and service providers, or our other third party providers, including technological or business-related disruptions and security breaches within a provider s service layer, could result in

Table of Contents

the loss or unauthorized disclosure of confidential information or otherwise adversely impact our business. In addition, fires, floods, earthquakes, power losses, telecommunications failures, break-ins and similar events could damage these third party systems, facilities and hardware or cause them to fail completely. A disrupting event could result in prolonged downtime of our operations and could adversely affect our business.

If we are unable to enter into, achieve desired results from, or maintain our marketing and promotional agreements with third party marketing or technology providers to generate sales traffic and sales for our clients, our ability to generate revenue and our business could be adversely affected.

We have entered into multiple marketing and promotional agreements and operate certain affiliate networks and programs which are designed to increase both traffic to the e-commerce stores we operate and the number of customers purchasing products through such stores, including agreements with search engine providers, display advertising networks, comparison shopping engines, affiliate networks, operators of websites and marketing technology providers. Our ability to attract new clients and retain existing clients is based in part on our ability to generate increased traffic or better conversion rates resulting in increased online sales of their products through these agreements and programs. If we are unable to enter into such agreements on favorable terms, are unable to achieve the desired results under these agreements and programs, are unable to maintain these relationships, or fail to generate sufficient traffic or generate sufficient revenue from purchases pursuant to these agreements and programs, our ability to generate sales and our ability to attract and retain our clients may be impacted, negatively affecting our business and operating results.

New obligations to collect or pay transaction taxes could substantially increase the cost to us of doing business.

Many of the laws and regulations regarding the application of sales tax, use tax, value added tax (VAT) or other similar transaction taxes predate the growth of the Internet and online commerce. The application of transaction taxes to interstate and international sales over the Internet is complex and evolving. We currently collect taxes on certain product and service offerings in tax jurisdictions where we have taxable presence. A successful assertion by one or more tax jurisdictions that we should collect or were obligated to collect transaction taxes on the products we sell could harm our results of operations. The imposition by state and local governments of various taxes upon Internet commerce and related e-commerce activities could create administrative burdens for us, put us at a competitive disadvantage if they do not impose similar obligations on all of our online competitors, and decrease our future sales.

Changes in our tax rates could affect our future results.

Our future effective tax rates could be favorably or unfavorably affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws or their interpretation. As of June 30, 2013, we had net deferred tax liabilities of $6.6 million. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our results of operations and financial condition.

Additional valuation allowances may be needed as we may not generate sufficient taxable income to utilize our deferred income tax assets.

We periodically assess whether it is more likely than not that we will generate sufficient taxable income to realize our deferred income tax assets and establish valuation allowances if it is not likely we will realize our deferred income tax assets. In making this determination, we consider all available positive and negative evidence and make certain assumptions. We consider, among other things, our deferred tax liabilities, the overall business environment, our historical financial results, and potential current and future tax planning strategies. At June 30, 2013, the Company had net deferred tax liabilities of $6.6 million. This amount includes a valuation allowance on approximately $11.3 million of deferred tax assets related to operating losses and $31.3 million of deferred tax assets related to other tax attributes as we believe it is more likely than not that these deferred tax assets will not be realized. We also have a valuation allowance on all of our foreign net operating losses of approximately $2.3 million. Our assessment is ongoing and may conclude that we require additional valuation allowances in the future. Any release of the valuation allowance would reduce income tax expense.

Failure to properly manage and sustain our expansion efforts could strain our management and other resources.

We expect to continue the expansion of our operations, both domestically and internationally, through a combination of organic growth and acquisitions. We will continue to expand further to pursue growth of our service offerings and customer base. This expansion increases the complexity of our business and places a significant strain on our management, operations, technical performance, financial resources, and internal financial control and reporting functions, and there can be no assurance that we will be able to manage it effectively. Our personnel, systems, procedures and controls may not be

Table of Contents

adequate to effectively manage our future operations, especially as we employ personnel in multiple domestic and international locations. We may not be able to hire, train, retain and manage the personnel required to address our growth. Failure to effectively manage our growth opportunities could damage our reputation, limit our future growth, negatively affect our operating results and harm our business.

Failure to properly manage and execute our plans to offer certain of our products and services on a modular basis could strain our resources and may not be successful in generating additional revenue.

We plan to offer certain of our product and service offerings on a modular basis. Offering product and services on a modular basis may require increases in costs of technology, marketing and business operations, and in the complexity of our business. This may place additional strain on our technical, operational and financial resources, and there can be no assurance that we will be able to manage or execute these plans effectively. Our personnel, systems, procedures and controls may not be adequate to effectively manage our future operations, especially as we seek to offer certain aspects of our products and services as standalone product and service offerings to clients and to implement a   go-to-market strategy for our modular offerings. We have not fully evaluated the market opportunity and demand for the use of our products and services on a modular basis. As we implement our plan, we may incur additional expenses without a corresponding increase in revenue. If we fail to effectively manage and execute our plans to modularize our product and service offerings, or fail to adequately market and generate demand for our modular offerings, we may not be able to successfully compete with other providers and may not be successful in generating additional revenue, which could harm our operating results and financial condition.

Our international expansion efforts may not be successful in generating additional revenue.

We sell products and services to consumers outside the United States and we intend to continue expanding our international presence. For the six months ended June 30, 2013, our sales to international consumers represented approximately 48.1% of our total sales. Continued expansion into international markets, particularly the European and Asia-Pacific regions, requires significant resources that we may fail to recover through generating additional revenue. Conducting business internationally is subject to risks that may have a material adverse effect on our ability to increase or maintain foreign sales, including:

- Changes in regulatory requirements and tariffs;
- Difficulties in staffing and managing foreign subsidiary operations, and the increased costs of international operations;
- Uncertainty of application of, and the burden and cost of complying with, local, commercial, tax, privacy and other laws and regulations;
- Reduced protection of intellectual property rights;
- Difficulties in physical distribution and logistics for international sales;
- Higher incidences of credit card fraud and difficulties in accounts receivable collection;
- Difficulties in transferring funds from certain countries;

- Difficulties in enforcing contracts against international clients, especially in emerging markets;

- Lower rates of Internet usage in certain countries, especially in emerging markets;

- Different employer/employee relationships, the existence of workers councils, and the possibility of unionization of our workforce outside the United States, particularly in Europe;

- Political, social and economic instability and constraints on international trade; and

- Import and export license requirements and restrictions of the United States and every other country in which we operate.

We may be unable to successfully and cost-effectively market, sell and distribute our services in foreign markets. Doing so may be more difficult or take longer than anticipated especially due to international challenges, such as language barriers, currency exchange issues and the fact that the Internet infrastructure in some foreign countries may be less advanced than the U.S. Internet infrastructure. As international e-commerce grows, our competition will continue to intensify. If we are unable to successfully expand our international operations, or manage this expansion, our operating results and financial condition could be harmed.

Implementing our acquisition and strategic partnership strategy could result in earnings dilution and operating difficulties and complexities leading to a decline in revenue and operating profit.

An important element of our long-term business strategy involves expansion through the acquisition of businesses, assets, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. On January 10th, 2013, we announced the formal completion of our acquisition of LML. As a result of the acquisition, we acquired all of the capital stock of LML at $3.45 per share cash settlement, or an aggregate purchase price of $102.8 million. The acquisition joins two complementary card-not-present payments businesses, positioning us to further capitalize on our global payment processing services. We

Table of Contents

also continually evaluate and explore other strategic opportunities as they arise, including business combination transactions, strategic partnerships, and the purchase or sale of assets, including tangible and intangible assets such as intellectual property. We have acquired, and intend to continue engaging in strategic acquisitions of businesses, technologies, services and products.

Acquisitions, strategic investments and strategic partnership agreements may require significant capital infusions, typically entail many risks, and could result in unforeseen difficulties, disruptions, distractions, and expenditures in assimilating and integrating with the operations, personnel, technologies, products and information systems of acquired companies or businesses. We have in the past and may in the future experience delays in the timing and successful completion of such activities. These challenges are magnified as the size of the acquisition increases. Furthermore, these challenges would be even greater if we acquired a business or entered into a business combination transaction with a company that was larger and more difficult to integrate than the companies we have historically acquired. Moreover, the anticipated benefits of any acquisition or strategic investment may not be realized. If a significant number of clients of the acquired businesses cease doing business with us, we would experience lost revenue and operating profit, and any synergies from the acquisition may be lost. In addition, key personnel of an acquired company may decide not to work for us. The acquisition of another company or its products and technologies may also require us to enter into a geographic or business market in which we have little or no prior experience. Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of debt, contingent liabilities, amortization of intangible assets or impairment of goodwill. Acquisitions could also result in a dilutive impact to our earnings.

Our clients   sales cycles and the implementation process for our commerce solution are time-consuming, which may cause us to incur substantial expenses and expend management time without generating corresponding consumer revenue, which would impair our cash flow.

We market our services directly to software publishers, online retailers, consumer electronics companies and other prospective customers. These relationships are typically complex and take time to finalize. Due to operating procedures in many organizations, a significant amount of time may pass between selection of our products and services by key decision-makers, the signing of a contract, and the launch of a revenue-generating commerce store. The period between the initial client sales call and the signing of a contract with significant sales potential is difficult to predict and typically ranges from six to twelve months, and completion of the implementation process typically ranges from one to four months. If at the end of a sales effort a prospective client does not purchase our products or services, we may have incurred substantial expenses and expended management time that cannot be recovered and that will not generate corresponding revenue. As a result, our cash flow and our ability to fund expenditures incurred during the sales cycle and implementation process may be impaired. We can incur substantial front-end costs to launch client sites and it may require a substantial time before those costs are recouped by us, if at all.

We may become liable for fraudulent, improper or illegal uses of our platforms and services.

In recent years revenues from our   self-service   platforms have grown as a percentage of our overall business, and we plan to continue to emphasize our self-service e-commerce solutions. These platforms typically have an automated structure that allows customers to sign up for and use our e-commerce services without significant participation from Digital River personnel. Despite our efforts to contractually prohibit the sale of inappropriate and illegal goods and services and our efforts to detect the same, the remote control nature of these platforms increases the risk that transactions involving the sale of unlawful goods or services or the violation of the proprietary rights of others may occur before we become aware of them. Furthermore, unscrupulous individuals may offer for sale, or attempt to purchase, illegal products via such platforms under innocuous names, further frustrating our attempts to prevent inappropriate use of our services. Failure to detect inappropriate or illegal uses of our platforms by third parties could expose us to a number of risks, including fines, increased fees or termination of services by payment processors or credit card associations, risks of lawsuits and governmental investigations, and civil and criminal penalties.

Compliance with and changes to applicable laws, rules, regulations, and certification requirements, may substantially increase our costs of doing business, limit our activities, or otherwise adversely affect our ability to offer our services.

We are subject to the same international, federal, state and local laws as other companies conducting business over the Internet. Because our services are accessible worldwide, and we facilitate sales of products to customers worldwide, international jurisdictions may claim that we are required to comply with their laws, rules and regulations. Laws regulating Internet companies outside of the United States may be less favorable than those in the United States, giving greater rights to consumers, content owners and users. Compliance with international, federal, state and local laws may be costly or may require us to change our business practices or restrict our service offerings relative to those provided in the United States. As our services are available over the Internet in multiple states and foreign countries, these jurisdictions may claim that we are required to qualify to do business as a foreign corporation in each state or foreign country. Failure to qualify as a foreign

Table of Contents

corporation in a required jurisdiction could subject us to taxes and penalties and could result in our inability to enforce contracts in these jurisdictions. Laws, rules and regulations applicable to our business include areas such as:

- User privacy with respect to adults and minors;
- Our ability to collect and/or share necessary information that allows us to conduct business on the Internet;
- Export compliance;
- Pricing, taxation, and regulatory fees;
- Fraud;
- Advertising;
- Intellectual property rights;
- Information security;
- Quality of products and services;
- Recycling of consumer products; and
- Our investments in other companies.

Our acceptance of credit cards and similar payment methods requires us to maintain certain certifications, most notably Payment Card Industry (PCI) Level 1 compliance. Maintaining this certification requires an annual audit by a qualified third party auditor and a review and assessment of our security controls and a significant commitment of internal resources. Our loss of such certification may result in our inability to process credit card transactions and other payments, and would have a material adverse effect on our ability to do business.

Violation of any laws, rules or regulations applicable to our business could result in fines or other actions by regulatory agencies, increased costs of doing business, reduced profits, or restrictions on our ability to conduct business such as our ability to export products or bans on our ability to offer certain services. In addition, any significant changes, developments, or new interpretations of laws, rules, and regulations applicable to our business will increase our costs of compliance and may further restrict our overseas client base, may require significant management and other resources to respond appropriately, and may harm our operating results.

Failure to protect our intellectual property may jeopardize our competitive position and require us to incur significant expenses to enforce our rights.

We rely on a combination of patent, copyright, trademark, service mark and trade secret laws, and contractual restrictions with our employees and other parties with which we do business, to protect our proprietary rights and to limit access to and disclosure of our proprietary information. We also seek to protect our proprietary position by filing U.S. patent applications related to our proprietary technology, inventions and improvements that are important to the development of our business, and the registration of our trademarks and service marks in the U.S. and internationally.

The steps we have taken to protect our proprietary rights may be inadequate and third parties may infringe or misappropriate our trade secrets, trademarks and similar proprietary rights. Our contractual arrangements and the other steps taken by us to protect our intellectual property may not prevent misappropriation of our technology or deter independent third-party development of similar technologies. We may not be able to successfully obtain patents or trademarks for our technologies or brands. Effective protection of our intellectual property rights may not be available in every country in which our services are made available online, or cost-effective for us to obtain on a worldwide basis. Any significant failure on our part to protect our intellectual property could make it easier for our competitors to offer similar services and thereby adversely affect our market opportunities. In addition, litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Litigation could result in substantial costs and diversion of management and technical resources.

Claims against us related to infringement of other parties intellectual property rights, by our products and services or the products we resell or deliver, could require us to expend significant resources, enter into unfavorable licenses, pay damages, prevent us from using certain technology, or require us to change our business plans.

From time to time we are notified of potential patent disputes, and expect that we will increasingly be subject to the assertion of patent infringement claims against us and/or our customers as our services expand in scope and complexity. We have been, and from time-to-time may be, named as a defendant in lawsuits claiming that we have, in some way, violated the intellectual property rights of others. For example, we were named as a defendant in a patent litigation in the United States District Court for the Eastern District of Texas brought against us and various other defendants by DDR Holdings, LLC, seeking injunctive and monetary relief. On October 12, 2012, the jury found in favor of the plaintiff on the infringement claim, and on June 20, 2013 the court awarded damages of $1.1 million (including pre-judgment interest, but excluding costs and post-judgment interest). We have appealed the outcome. See Item I, Note 8 for additional information on the DDR Holdings litigation and other claims against us.

Litigation over patents and other intellectual property rights is not uncommon with respect to e-commerce technologies, and

Table of Contents

often involves patent holding companies or other adverse patent owners who have no relevant product revenues and against whom our own patents may therefore provide little or no deterrence.

Claims may be made against us for negligence, copyright or trademark infringement, products liability or other theories based on the nature and content of software products or tangible goods that we deliver electronically and physically. Because we did not create these products, we are generally not in a position to know the quality or nature of the content of these products.

Any assertions or prosecutions of intellectual property claims could require us to expend significant financial, managerial and personnel resources. Although we carry general liability insurance and typically require that our customers indemnify us against consumer claims, our insurance and indemnification measures may not cover potential claims of this type, may not adequately cover all costs incurred in defense of potential claims, or may not reimburse us for all liability that may be imposed. We may elect to self-insure against certain claims. The defense of any claims, with or without merit, could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause product enhancement delays or require that we develop non-infringing technology or enter into royalty or licensing agreements. Royalty or licensing agreements, if required, may be unavailable on terms acceptable to us or at all. In the event of a successful claim of infringement against us and our failure or inability to develop non-infringing technology or license the infringed or similar technology on a timely basis, we may be unable to continue to pursue our current business plan. We expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity, and our results of operations and financial condition could be materially adversely affected.

We are subject to regulations relating to consumer privacy and the protection of personal information.

We collect and maintain customer data from our customers, which subjects us to increasing international, federal and state regulations related to online privacy and the use of personal user information. Congress has enacted anti-spam legislation with which we must comply when providing email campaigns for our clients. Legislation and regulations are pending in various domestic and international governmental bodies that address online privacy protections. Several governments have proposed, and some have enacted, legislation that would limit the use and transfer of personal user information or require online service providers to establish privacy policies. In addition, the U.S. Federal Trade Commission (FTC) has urged Congress to adopt legislation regarding the collection and use of personal identifying information obtained from individuals when accessing websites, including both adults and minors. The FTC and certain states, such as California, have released guidance for privacy practices associated with applications used on mobile devices such as smartphones and tablets.

Even in the absence of laws requiring companies to establish these procedures, the FTC has settled several proceedings resulting in consent decrees in which Internet companies have been required to establish programs regarding the manner in which personal information is collected from users and provided to third parties. We could become a party to a similar enforcement proceeding. These regulatory and enforcement efforts could limit our collection of and/or ability to share with our clients demographic and personal information from customers, which could adversely affect our ability to comprehensively serve our clients.

The European Union has adopted a privacy directive that regulates the collection and use of information that identifies an individual person, and in January 2012 released a proposed revision to its privacy framework to replace the existing directive with a privacy regulation. The existing directive, and the proposed regulation if adopted, may inhibit or prohibit the collection and sharing of personal information in ways that could harm our clients or us. Failure to comply with member state implementations of the existing directive, or with the proposed regulation if adopted, may result in fines, private lawsuits and enforcement actions. These enforcement actions can include interruption or shutdown of operations relating to the collection and sharing of information pertaining to citizens of the European Union. Other countries including the United States have introduced or may seek to expand their existing data privacy laws, rules and regulations, which could require us to expend significant resources to implement procedures and processes to ensure our compliance.

We have and post on our websites our own privacy statements, policies and practices concerning our collection, use and disclosure of user information. The FTC, state and international regulatory agencies continue to be aggressive in enforcing privacy and data protection laws and regulations. Any actual or perceived failure by us to comply with our posted privacy statements, policies and practices or with federal, state or international data privacy laws, rules and regulations could reduce consumer confidence in conducting transactions processed through our systems, and could result in actions or proceedings against us by governmental entities, individual or class action litigation, subject us to significant penalties and negative publicity, require us to change our business practices, increase our costs and adversely affect our business.

System failures, outages or errors could reduce the attractiveness of our service offerings.

We provide commerce, marketing and delivery services to our clients and consumers through our proprietary technology transaction processing and client management systems. These systems also maintain an electronic inventory of

Table of Contents

products and gather consumer marketing information. The satisfactory performance, reliability and availability of the technology and the underlying network infrastructure are critical to our operations, level of client service, reputation and ability to attract and retain clients. We have experienced periodic interruptions and have identified errors, affecting all or a portion of our systems, which we believe will continue to occur from time-to-time. While we attempt to correct every system error we identify, not all errors may be identified or corrected. Any systems damage, errors, or interruption that impairs our ability to accept and fill client orders could result in an immediate loss of revenue to us, and could cause some clients to purchase services offered by our competitors. In addition, frequent systems failures could harm our reputation.

Although we maintain system redundancies in multiple physical locations, our systems and operations are vulnerable to damage or interruption from:

- Fire, flood, natural disasters, and other events beyond our control;
- Defects introduced by 3rd party technology;
- Defects introduced by outsourced services;
- 3rd party and outsourced services technology failure due to defects in hardware and or firmware;
- Catastrophic hardware failure of 3rd party;
- Catastrophic hardware failure of outsourced service provider;
- Errors introduced by software and or hardware maintenance;
- Operator negligence, improper operation by, or supervision of, employees, physical and electronic break-ins, misappropriation, computer viruses and similar events; and
- Power loss, computer systems failures, denial-of-service attacks and Internet and telecommunications failure.

We may not carry sufficient business interruption insurance to fully compensate us for losses that may occur.

The listing of our network addresses on anti-spam lists could harm our ability to service our clients and deliver goods over the Internet.

Certain privacy and anti-email proponents have engaged in a practice of gathering, and publicly listing, network addresses that they believe have been involved in sending unwanted, unsolicited emails commonly known as spam. In response to user complaints about spam, Internet service providers have, from time to time, blocked such network addresses from sending emails to their users. If our network addresses mistakenly end up on these spam lists, our ability to provide services for our clients and consummate the sales of digital and physical goods over the Internet could be harmed.

If our internal control over financial reporting or disclosure controls and procedures are not effective, there may be errors in our financial statements that could require a restatement or our filings may not be timely and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price.

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in each Annual Report on Form 10-K. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Over time, controls may become inadequate because changes in conditions or deterioration in the degree of compliance with policies or procedures may occur. Implementation of new technology related to the control system, such as our current ongoing implementation of an SAP Enterprise Resource Planning, or ERP, system, may result in misstatements due to errors that are not detected and corrected during testing. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

As a result, we cannot assure you that significant deficiencies or material weaknesses in our internal control over financial reporting will not be identified in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could result in significant deficiencies or material weaknesses, cause us to fail to timely meet our periodic reporting obligations, or result in material misstatements in our financial statements. Any such failure could also adversely affect the results of periodic management evaluations and annual auditor reports regarding disclosure controls and the effectiveness of our internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act of 2002 and the rules proclaimed after that. The existence of a material weakness could result in errors in our financial statements that could result in a restatement of financial statements, cause us to fail to timely meet our reporting obligations and cause investors to lose confidence in our reported financial information, leading to a decline in our stock price.

Table of Contents

Developments in accounting standards may cause us to increase our recorded expenses, which in turn would jeopardize our ability to demonstrate sustained profitability.

In January 2002, we adopted new Financial Accounting Standards Board (FASB) guidance that establishes that goodwill and intangible assets with indefinite lives are not amortized, but are to be tested on an annual basis (or more frequently if there are indications that an impairment may be necessary) for impairment and, if impaired, are recorded as an impairment charge in income from operations. We perform our annual goodwill impairment test in October. As we only have one business segment, goodwill is evaluated based on a single reporting unit.

During the first quarter of 2013, we determined the fair market value of the privately held equity security, which we had estimated at year end, and completed our goodwill impairment analysis. As a result of our analysis we recorded an additional non-cash pretax goodwill impairment charge of $21.2 million relating to our single reporting unit. These goodwill charges are included as a separate operating expense line item, Goodwill impairment in our Consolidated Statements of Operations. The tax benefit was offset by our current period tax valuation allowance. A blended income and market approach was used to determine the fair value of our sole reporting unit and associated impairment charges. The application of goodwill impairment tests requires management judgment for many of the inputs. Key assumptions included in the impairment test included our revenue growth rate, discount rate assumptions, and estimates of our future cash flows. Changes in these estimates could result in additional impairment of goodwill in a future period. The impairment charge reflects our view of anticipated risks based on our expectations of market and general economic conditions. As of June 30, 2013, we had goodwill with an indefinite life of $138.3 million from our acquisitions. In the future, if our goodwill is determined for any reason to be impaired, the subsequent accounting of the impaired portion as an expense would lower our earnings. In January 2008, we adopted new FASB guidance that requires the reporting of assets at fair value defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of assets can shift significantly and can cause a permanent or temporary impairment.

Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management.

We are incorporated in Delaware. Certain anti-takeover provisions under Delaware law and in our certificate of incorporation and amended and restated bylaws, as currently in effect, may make a change of control of our company more difficult, even if a change in control would be beneficial to our stockholders. Our anti-takeover provisions include provisions such as a prohibition on stockholder actions by written consent, a classified board of directors and the authority of our board of directors to issue preferred stock without stockholder approval. In addition, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which generally prohibits stockholders owning 15% or more of our outstanding voting stock from merging or combining with us in certain circumstances. These provisions may delay or prevent an acquisition of us, even if the acquisition may be considered beneficial by some of our stockholders. In addition, they may frustrate or prevent any attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management.

Risks Related to Our Industry

Because the e-commerce industry is highly competitive and has low barriers to entry, we may be unable to compete effectively.

The market for e-commerce solutions is extremely competitive and we may find ourselves unable to compete effectively. Because there are relatively low barriers to entry in the e-commerce market, we expect continued intense competition as current competitors expand their product offerings and new competitors enter the market. In addition, our clients and partners may become competitors in the future. Increased competition is likely to result in price reductions, reduced margins, longer sales cycles and a decrease or loss of our market share, any of which could negatively impact our revenue and earnings. We face competition from the following sources:

- In-house development of e-commerce capabilities using tools or applications from companies, such as Oracle Corporation (which acquired Art Technology Group, Inc.), IBM Corporation, Demandware, Inc. and hybris GmbH, or through internally developed solutions;

- E-Commerce capabilities custom-developed by companies, such as IBM Global Services and Accenture, Inc.;

- New e-commerce models through which consumers can purchase software products for their computers and computing devices, such as app stores;

- Other providers of outsourced e-commerce solutions, such as cleverbridge AG, eBay, Inc. (which acquired GSI Commerce, Inc.), Demandware Inc., Avangate BV, asknet AG and arvato Systems, a division of Bertelsmann AG;

Table of Contents

- Companies that provide technologies, services or products that support a portion of the e-commerce process, such as payment processing, including WorldPay Ltd., GlobalCollect, CyberSource Corporation (a subsidiary of Visa, Inc.), Square, Inc., and PayPal Corporation (a subsidiary of eBay, Inc.);

- Companies that offer various online marketing services, technologies and products, including ValueClick, Inc. and Microsoft Advertising (formerly aQuantive, Inc.);

- High-traffic, branded websites that generate a substantial portion of their revenue from e-commerce and may offer or provide to others the means to offer their products for sale, such as Amazon.com, Inc. and Buy.com, Inc.; and,

- Web hosting, web services and infrastructure companies that offer portions of our solution and are seeking to expand the range of their offering, such as Network Solutions, LLC, Akamai Technologies, Inc., Yahoo!, Inc., eBay, Inc. and Hostopia.com, Inc.

The online channel partners and the other companies described above may compete directly with us by adopting a business model similar to ours. Many of our competitors have, and new potential competitors may have, more experience developing Internet-based software and e-commerce solutions, larger technical staffs, larger customer bases, more established distribution channels and customer relationships, greater brand recognition and greater financial, marketing and other resources than we have. Some of our clients may also compete with us. In addition, competitors or our clients may be able to develop services that are superior to our services, achieve greater customer acceptance or have significantly improved functionality as compared to our existing and future products and services, which could result in the loss of existing clients and/or our inability to pursue and sign new clients. Our competitors may be able to respond more quickly to technological developments and changes in customers needs. Our inability to compete successfully against current and future competitors could cause our revenue and earnings to decline.

The pace of recovery of U.S. and global economies, political and economic conditions, and the debt crisis in the United States and other countries may adversely affect our revenue and results of operations and stock price.

The U.S. and other global economies continue to experience slow recovery from the recent recession that affected the economy as a whole, resulting in continued issues with the pace of economic growth, continued weakness in consumer confidence and uncertainty about economic stability, and increased unemployment. U.S. and foreign credit and financial markets continue to experience periods of instability. The U.S. continues to face budgetary issues and constraints which may result in a failure to raise the debt ceiling and austerity measures such as automatic sequesters, cuts in government spending and programs, increased taxes, and other related actions or inactions by the U.S. government. Other countries and economies continue to experience adverse effects of sovereign debt crises and related austerity measures. These issues may cause a cascading effect impacting other countries and economies. Our revenue and growth is dependent on the continued growth in demand for our clients products and the continued growth of Internet commerce, and depends significantly on geopolitical economic and business conditions. The continuing effects of instability in the credit and financial markets, general economic conditions, and the approach to addressing debt crises and austerity measures in the U.S. and other countries may continue to negatively impact our business and our clients, demand for our clients products, and consumer spending, such as causing delays in new product introductions, changes in client s outsourcing behavior, increasing our difficulty in collecting client receivables, and increasing the risk of client bankruptcies and/or interruption or cessation of business, which may have a negative impact on our business, operating results and financial condition. These factors could have a negative and adverse impact on companies with which we do business, which in turn could have a negative and adverse effect on our business. Continuing geopolitical instability in certain countries and regions may affect consumer spending behavior in those countries and regions. Instability in the credit and equity markets increases the risk that the actual amounts realized in the future on our financial instruments and investments may significantly differ from the fair values currently assigned to them. If macroeconomic and market conditions affecting us or our clients remain uncertain, weaken further, or otherwise fail to improve, they may have a material adverse effect on our business, operating results, financial condition and stock price.

Risks Related to the Securities Markets

We may need to raise additional capital to achieve our business objectives, which could result in dilution to existing investors or increase our debt obligations.

We require substantial working capital to fund our business. In February 2009, we filed a shelf registration that would allow us to sell an undetermined amount of equity or debt securities in accordance with the rules applying to well-known seasoned issuers. In addition, we filed an acquisition shelf registration statement for up to approximately 1.5 million shares. On November 1, 2010, we sold and issued $345.0 million in aggregate principal amount of senior convertible notes (2010 Notes), in a private, unregistered offering. If additional funds are raised through the issuance of equity securities, the percentage ownership of our stockholders will be reduced and these equity securities may have rights, preferences or privileges senior to those of our common stock. Our capital requirements depend on several factors, including the rate of

Table of Contents

market acceptance of our products, the ability to expand our client base, the growth of sales and marketing and opportunities for acquisitions of other businesses. We have experienced significant operating losses and negative cash flow from operations during our operating history and may do so in the future. Additional financing may not be available when needed, on terms favorable to us or at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to develop or enhance our services, take advantage of future opportunities or respond to competitive pressures, which would harm our operating results and adversely affect our ability to sustain profitability.

The investment of our substantial cash balance and our investments in marketable debt securities are subject to risks which may cause losses and affect the liquidity of these investments.

As of June 30, 2013, we held $45.7 million of auction rate securities (ARS) at par value which we have recorded at $40.1 million fair value. The ARS are over-collateralized and the underlying student loans are guaranteed by the U.S. government. These securities are BB+ to AAA rated and almost all continue to fail at auction due to continued illiquid market conditions.

Due to the illiquid market conditions, we recorded a temporary fair value reduction of our ARS in the amount of $5.6 million (12.2% of par value) as of June 30, 2013, under Accumulated other comprehensive income (loss).

The investment principal associated with failed auctions will not be accessible until successful auctions occur, a buyer is found outside of the auction process, the issuers establish a different form of financing to replace these securities, or final payments come due according to the contractual maturities of the debt issues. If none of these events occur or if the credit markets deteriorate, we may in the future be required to take a larger fair value discount and may be required to take a permanent impairment resulting in a reduction of earnings and liquidity. We intend to hold our auction rate securities until we can recover the full principal amount and have the ability to do so based on our other sources of liquidity. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Set forth below is information regarding the Company s stock repurchases during the three months ended June 30, 2013.

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plan	Approximate dollar value of shares that may yet be purchased under the plan (in millions)
April 1, 2013 - April 30, 2013		$		$ 86.4
May 1, 2013 - May 31, 2013	280,075	$ 16.62	280,075	$ 81.8
June 1, 2013 - June 30, 2013	851,089	$ 18.11	851,089	$ 66.3
Total	1,131,164		1,131,164	

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

See exhibits listed under the Exhibit Index below.

Table of Contents

SIGNATURES

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.

Date:	August 6, 2013		DIGITAL RIVER, INC.
		By:	/s/ Stefan B. Schulz
			Stefan B. Schulz *Chief Financial Officer* *(Principal Financial Officer)*

Table of Contents

EXHIBIT INDEX

EXHIBIT NUMBER		DESCRIPTION OF DOCUMENTS
3.1	(1)	Amended and Restated Certificate of Incorporation, as amended, as currently in effect.
3.2	(2)	Amended and Restated Bylaws, as currently in effect.
4.1	(3)	Specimen of Common Stock Certificate.
4.2	(4)	Indenture dated as of September 1, 2004 between Digital River, Inc. and Wells Fargo Bank, N.A. as trustee, including therein the form of the 2004 Note.
4.3	(5)	Indenture dated as of November 1, 2010, between Digital River, Inc. and Wells Fargo Bank, N.A. as trustee, including therein the form of the 2010 Note.
31.1		Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2		Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1		Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2		Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101		The following financial information from Digital River, Inc. s Quarterly Report on Form 10-Q for the period ended June 30, 2013, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Cash Flows, and (iv) Notes to Consolidated Financial Statements.*

(1) Filed as an exhibit to the Company s Current Report on Form 8-K, filed on June 1, 2006, and incorporated herein by reference.
(2) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2000, filed on March 27, 2001, and incorporated herein by reference.
(3) Filed as an exhibit to our Registration Statement on Form S-1, File No. 333-56787, declared effective on August 11, 1998, and incorporated herein by reference.
(4) Incorporated by reference from the Company s Current Report on Form 8-K filed on July 13, 2004.
(5) Filed as an exhibit to the Company s Current Report on Form 8-K filed on November 1, 2010, and incorporated herein by reference.
* Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be deemed part of a registration statement, prospectus or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filings.