

DIGITAL RIVER INC /DE
Form 10-Q
August 05, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2011

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE
(State or other jurisdiction of
incorporation or organization)

41-1901640
(I.R.S. Employer
Identification Number)

9625 WEST 76TH STREET

EDEN PRAIRIE, MINNESOTA 55344

(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 No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company (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 Accelerated filer

Non-accelerated filer Smaller reporting company

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

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, 2011, was 39,684,466 shares.

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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, 2011	December 31, 2010
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 432,454	\$ 565,086
Short-term investments	276,200	163,029
Accounts receivable, net of allowance of \$4,347 and \$4,902	55,803	50,922
Deferred tax assets	10,730	10,628
Prepaid expenses and other	36,578	30,375
Total current assets	811,765	820,040
Property and equipment, net	48,063	49,599
Goodwill	297,222	283,940
Intangible assets, net of accumulated amortization of \$86,211 and \$80,106	33,199	37,911
Long-term investments	109,055	110,736
Deferred income taxes	17,699	17,721
Other assets	11,315	13,820
TOTAL ASSETS	\$ 1,328,318	\$ 1,333,767
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 172,049	\$ 188,915
Accrued payroll	14,402	21,117
Deferred revenue	10,045	10,446
Accrued acquisition liabilities		1,615
Other accrued liabilities	39,958	58,083
Total current liabilities	236,454	280,176
NON-CURRENT LIABILITIES		
Senior convertible notes	353,805	353,805
Other liabilities	14,868	16,038
Total non-current liabilities	368,673	369,843
TOTAL LIABILITIES	605,127	650,019

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STOCKHOLDERS EQUITY		
Preferred Stock, \$.01 par value; 5,000,000 shares authorized; no shares issued or outstanding		
Common Stock, \$.01 par value; 120,000,000 shares authorized; 47,150,551 and 46,323,799 shares issued	471	463
Treasury stock at cost; 7,466,085 and 7,297,174 shares	(260,952)	(255,196)
Additional paid-in capital	696,775	683,307
Retained earnings	261,912	254,602
Accumulated other comprehensive income (loss)	24,985	572
Total stockholders equity	723,191	683,748
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 1,328,318	\$ 1,333,767

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,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenue	\$ 92,520	\$ 81,832	\$ 190,705	\$ 180,558
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	3,856	4,356	8,019	8,993
Network and infrastructure	12,477	12,118	25,089	23,550
Sales and marketing	39,492	36,159	77,198	77,209
Product research and development	18,106	16,221	33,726	31,910
General and administrative	10,867	10,766	21,623	21,595
Depreciation and amortization	5,559	6,095	10,964	11,576
Amortization of acquisition-related intangibles	2,205	1,612	4,327	3,093
Total costs and expenses	92,562	87,327	180,946	177,926
Income (loss) from operations	(42)	(5,495)	9,759	2,632
Interest income	1,753	608	3,228	1,372
Interest expense	(2,243)	(55)	(4,500)	(122)
Other income (expense), net	672	55	538	907
Income (loss) before income taxes	140	(4,887)	9,025	4,789
Income tax expense (benefit)	(151)	(2,407)	1,715	302
Net income (loss)	\$ 291	\$ (2,480)	\$ 7,310	\$ 4,487
Net income (loss) per share - basic	\$ 0.01	\$ (0.07)	\$ 0.20	\$ 0.12
Net income (loss) per share - diluted	\$ 0.01	\$ (0.07)	\$ 0.19	\$ 0.12
Shares used in per-share calculation - basic	37,436	37,577	37,415	37,548
Shares used in per-share calculation - diluted	37,981	37,577	38,105	38,345

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,	
	2011	2010
OPERATING ACTIVITIES		
Net income (loss)	\$ 7,310	\$ 4,487
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of acquisition-related intangibles	4,327	3,093
Provision for doubtful accounts	684	1,769
Depreciation and amortization	10,964	11,576
Debt issuance cost amortization	998	
Stock-based compensation expense	10,686	9,998
Excess tax benefits from stock-based compensation	(1,474)	(502)
Deferred and other income taxes	1,151	(231)
Change in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(3,754)	8,347
Prepaid and other assets	(2,236)	1,555
Accounts payable	(23,684)	(49,686)
Deferred revenue	(675)	(14)
Income tax payable	(1,939)	2,680
Other accrued liabilities	(29,241)	(15,264)
Net cash provided by (used in) operating activities	(26,883)	(22,192)
INVESTING ACTIVITIES		
Purchases of investments	(191,634)	(33,155)
Sales of investments	83,646	20,150
Cash paid for acquisitions, net of cash received		(8,950)
Purchases of equipment and capitalized software	(9,136)	(10,291)
Net cash provided by (used in) investing activities	(117,124)	(32,246)
FINANCING ACTIVITIES		
Debt issuance costs	(342)	
Exercise of stock options	315	866
Sales of common stock under employee stock purchase plan	1,251	1,138
Repurchase of restricted stock to satisfy tax withholding obligation	(5,756)	(3,119)
Excess tax benefits from stock-based compensation	1,474	502
Net cash provided by (used in) financing activities	(3,058)	(613)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	14,433	(25,866)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(132,632)	(80,917)
CASH AND CASH EQUIVALENTS, beginning of period	565,086	392,704
CASH AND CASH EQUIVALENTS, end of period	\$ 432,454	\$ 311,787

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SUPPLEMENTAL DISCLOSURES

Cash paid for interest on senior convertible notes	\$ 3,505	\$ 55
Cash paid for income taxes	\$ 2,275	\$ 2,754

See accompanying notes to consolidated financial statements.

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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, 2010, as filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2011, are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2011. The December 31, 2010, 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, 2010. There were no material changes in significant accounting policies during the quarter ended June 30, 2011.

Restricted Cash

Restricted cash consists of cash and cash equivalents that are held in escrow accounts and 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, 2011, we had \$1.5 million of restricted cash, and \$2.1 million of restricted cash as of December 31, 2010.

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, 2011 and 2010, we capitalized \$1.1 million and \$2.0 million related to software development, respectively. For the six months ended June 30, 2011 and 2010, we capitalized \$3.1 million and \$3.0 million related to software development, respectively. This capitalization is primarily related to the development of our enterprise resource planning (ERP) system, new data management and reporting infrastructure. We expect these investments to drive long-term operational efficiencies across the organization and provide further competitive differentiation.

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. Comprehensive income (loss) is net of income tax benefit or expense excluding cumulative translation adjustments as these funds are indefinitely invested.

The components of comprehensive income (loss) are (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net Income (loss)	\$ 291	\$ (2,480)	\$ 7,310	\$ 4,487
Other comprehensive income (loss):				
Unrealized foreign exchange gain (loss) on the revaluation of investments in foreign subsidiaries	6,170	(26,090)	23,800	(41,423)
Unrealized gain (loss) on investments	255	(279)	1,169	(171)
Tax benefit (expense)	(265)	97	(556)	56
Other comprehensive income (loss)	6,160	(26,272)	24,413	(41,538)
Comprehensive income (loss)	\$ 6,451	\$ (28,752)	\$ 31,723	\$ (37,051)

Foreign Currency

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.

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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. These exposures are mitigated by the use of foreign exchange forward contracts with maturities of approximately one week. Our derivatives are not designated as hedges and are adjusted to fair value through income each period. The principal exposures mitigated were euro, pound sterling and Australian dollar currencies. For the three and six months ended June 30, 2011 and June 30, 2010, the gain/loss on derivative settlements was immaterial. As of June 30, 2011 and December 31, 2010, the notional amounts held 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

Accounting Standards Update (ASU) 2009-13 Multiple-Deliverable Revenue Arrangements: In October 2009, the Financial Accounting Standards Board (FASB) issued ASU 2009-13. This update provides amendments to Accounting Standards Codification (ASC) Topic 605 Revenue Recognition that enables vendors to account for products or services (deliverables) separately rather than as a combined unit. The amendments eliminate the residual method of allocation and require that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. The amendments also require that a vendor determine its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a standalone basis. Additionally, disclosures related to multiple-deliverable revenue arrangements have also been expanded. The provisions were effective for fiscal years beginning on or after June 15, 2010. We have adopted the new guidance in ASU 2009-13 as of January 1, 2011, and it did not have a material impact on our Consolidated Financial Statements.

ASU 2010-28 Goodwill Impairment Testing: In December 2010, the FASB issued ASU 2010-28. This update provides amendments to ASC Topic 350 Intangibles-Goodwill and Other that require additional qualitative analysis within step 1 of the goodwill impairment test if a reporting unit's carrying value is zero or negative. If it is more likely than not that a goodwill impairment exists, step 2 of the goodwill impairment test is required. We have adopted the new guidance in ASU 2010-28 as of the period ended March 31, 2011, and it did not have a material impact on our Consolidated Financial Statements.

ASU 2010-29 Disclosure of Supplementary Pro Forma Information for Business Combinations: In December 2010, the FASB issued ASU 2010-29. This amendment to ASC Topic 805 Business Combinations requires public entities to disclose pro forma revenue and earnings of a combined entity for the current reporting period for all material business combinations as though the acquisition date that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, this same disclosure requirement is applicable. Additionally, supplemental pro forma disclosures were amended to require a description of the nature and amount of material pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. We have adopted the new disclosure requirements as of the period ended March 31, 2011.

ASU 2011-04 Fair Value Measurements: In May 2011, the FASB issued ASU 2011-04. This update provides amendments to ASC Topic 820 - Fair Value Measurements and Disclosures by creating a uniform framework for applying fair value measurements principles and clarified existing guidance in U.S. GAAP. The amendments called for additional disclosures regarding quantitative information about the significant unobservable inputs used for all Level 3 measurements, information about the sensitivity of a fair value measurement categorized within Level 3 of the fair value hierarchy to changes in unobservable inputs and any interrelationships between those unobservable inputs and a description of the valuation process. Additionally, disclosures are required when current use of a non-financial assets measured at fair value differs from its highest and best use, any transfers from Level 1 and Level 2 and the hierarchy classification for items whose fair value is not recorded on the balance sheet but disclosed in the footnotes. ASU No. 2011-04 is effective for interim and annual periods beginning after December 15, 2011, and is to be completed on a prospective basis. Adoption of ASU 2011-04 is not anticipated to have a material impact on our Consolidated Financial Statements.

ASU 2011-05 Comprehensive Income: In June 2011, the FASB issued ASU 2011-05. This amendment requires nonowner changes in stockholders' equity, reclassifications and all other items affecting comprehensive income be presented in either a single continuous statement or in two separate but consecutive statements for all periods presented. The amendments do not change the items that must be reported in comprehensive income or when an item of other comprehensive income must be

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reclassified to net income (loss). ASU No. 2011-05 is effective for interim and annual periods beginning after December 15, 2011, and is to be completed on a retrospective basis. Adoption of ASU 2011-05 is not anticipated to 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.

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,	
	2011	2010	2011	2010
Net income (loss) per share - basic				
Net income (loss) - basic	\$ 291	\$ (2,480)	\$ 7,310	\$ 4,487
Weighted average shares outstanding - basic	37,436	37,577	37,415	37,548
Net income (loss) per share - basic	\$ 0.01	\$ (0.07)	\$ 0.20	\$ 0.12
Net income (loss) per share - diluted				
Net income (loss) - basic	\$ 291	\$ (2,480)	\$ 7,310	\$ 4,487
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit				42
Net income (loss) - diluted	\$ 291	\$ (2,480)	\$ 7,310	\$ 4,529
Weighted average shares outstanding - basic	37,436	37,577	37,415	37,548
Dilutive impact of non-vested stock and options outstanding	545		690	597
Dilutive impact of 2004 senior convertible notes				200
Weighted average shares outstanding - diluted	37,981	37,577	38,105	38,345
Net income (loss) per share - diluted	\$ 0.01	\$ (0.07)	\$ 0.19	\$ 0.12

For the three months ended June 30, 2010, 773,560 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 this period. 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 714,705 and 1,460,388 shares for the three months ended June 30, 2011 and 2010, respectively, and 708,142 and 1,460,338 shares for the six months ended June 30, 2011 and 2010, 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 shares for three and six months ended June 30, 2011, 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, 7,022,027 shares for three and six months ended June 30, 2011, 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

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Financial assets and liabilities that are re-measured 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 non-active markets;

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.

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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, 2011 and December 31, 2010, (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, 2011				
Cash and cash equivalents	\$ 432,454	\$ 432,454	\$	\$
Restricted cash	1,506	1,506		
U.S. government sponsored entities	53,110	53,110		
Corporate bonds	189,413	189,413		
Asset backed securities	33,677	33,677		
Market basis equity investments	3,823	3,823		
Student loan bonds	79,989			79,989
Total assets measured at fair value	\$ 793,972	\$ 713,983	\$	\$ 79,989
Balance as of December 31, 2010				
Cash and cash equivalents	\$ 565,086	\$ 565,086	\$	\$
Restricted cash	2,070	2,070		
Certificates of deposit	93	93		
U.S. government sponsored entities	34,965	34,965		
Corporate Bonds	121,944	121,944		
Asset backed securities	6,027	6,027		
Market basis equity investments	3,818	3,818		
Student loan bonds	83,678			83,678
Total assets measured at fair value	\$ 817,681	\$ 734,003	\$	\$ 83,678

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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):

	Short-term Investments	(Level 3) Long-term Investments	Total
Balance as of December 31, 2009	\$	\$ 92,801	\$ 92,801
Total gains or losses (realized/unrealized) included in other comprehensive income		(623)	(623)
Purchases			
Issuances			
Settlements		(8,500)	(8,500)
Transfers in and/or out of Level 3			
Balance as of December 31, 2010		83,678	83,678
Total gains or losses (realized/unrealized) included in other comprehensive income		336	336
Purchases			
Issuances			
Settlements		(4,025)	(4,025)
Transfers in and/or out of Level 3			
Balance as of June 30, 2011	\$	\$ 79,989	\$ 79,989

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. The fair value was measured using quoted market prices and is classified as Level 1. The carrying amount approximates fair value.

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

Certificates of Deposit. Consist of time deposit accounts with original maturities of less than one year and various yields. The carrying amount approximates fair value and is classified as Level 1.

U.S. Government Sponsored Entities. Consist of Fannie Mae, Freddie Mac and Federal Home Loan Bank investment grade 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 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 that are backed by automobile loan receivables that trade with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The fair value of these securities was measured using quoted market prices and is classified as Level 1. The contractual maturity of these investments is within two years.

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.

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Auction Rate Securities (Student loan bonds in table). As of June 30, 2011, we held \$86.6 million of auction rate securities (ARS) at par value which we have recorded at \$80.0 million fair value. As of December 31, 2010, we held \$90.6 million of ARS at par value which was recorded at \$83.7 million fair value. All of the ARS are AAA/Aaa rated and 105%-115% over collateralized by student loans guaranteed by the U.S. government with the exception of one security which is rated AAA/A3 and one security which is rated AAA/Aa1. Almost all of these securities continue to fail at auction due to continued illiquid market conditions.

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Due to the illiquid market conditions, we recorded a temporary fair value reduction of our ARS in the amount of \$6.6 million (7.6% of par value) in our balance sheet ended June 30, 2011, under Accumulated other comprehensive income (loss), compared to a \$6.9 million temporary fair value reduction in 2010 (7.6% of par value). The determination of fair value required management to make estimates and assumptions about the ARS. The discounted cash flow model we used to value these securities included the following assumptions:

determination of the penalty coupon rate and the frequency of the reset period associated with each ARS

an average redemption period of seven years

a contribution of the ARS paying its contractually stated interest rate

determination of the risk adjusted discount rate based on LIBOR rates for these maturities plus market information on student loan credit spreads

The aggregate ARS portfolio had an annualized yield of 1.4% as of June 30, 2011, compared to a yield of 1.7% as of December 31, 2010. We continue to receive 100% of the contractually required interest payments. The portfolio had a weighted average maturity of 28.5 years and 29.3 years as of June 30, 2011 and December 31, 2010, respectively. 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 investing alternatives.

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, 2011 and December 31, 2010, our entire ARS portfolio was classified as Level 3 long-term investments. As of June 30, 2011, the difference between fair value and par value of the ARS was \$6.6 million, or 0.8% of total assets measured at fair value or 0.5% of total assets reported in our financial statements. In the six months ended June 30, 2011, we liquidated \$4.0 million of ARS due to full or partial calls at par. During the fiscal year ended December 31, 2010, we liquidated \$8.5 million of ARS due to full or partial calls at par.

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

In the second quarter of 2011, we had no significant measurements of assets or liabilities at fair value on a nonrecurring basis subsequent to their initial recognition.

The aggregate carrying value and fair value of the Company's cost method equity investments at June 30, 2011, and December 31, 2010, was \$25.2 million and \$23.2 million, respectively and is included in the long-term investments line item on the balance sheet. The increase in carrying value was due to translation adjustments from investments we acquired in late 2009. We have evaluated the investments for impairment and we believe that the entity valuations completed at acquisition and the investee's subsequent performance against those projections indicates that the acquisition price continues to represent fair value.

As of June 30, 2011 and December 31, 2010, the fair value of our \$345.0 million 2.0% fixed rate 2010 senior convertible notes was valued at \$344.9 million and \$338.3 million, respectively, based on the quoted fair market value of the debt.

As of June 30, 2011 and December 31, 2010, the fair value of our \$8.8 million 1.25% fixed rate 2004 senior convertible notes was valued at \$8.8 million and \$9.0 million, respectively, based on the quoted fair market value of the debt.

Table of Contents**4. INVESTMENTS**

As of June 30, 2011, and December 31, 2010, our available-for-sale securities consisted of the following (in thousands):

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Maturities/Reset Dates Less than 12 Months	Greater than 12 Months
Balance as of June 30, 2011						
U.S. government sponsored entities	\$ 53,064	\$ 58	\$ (12)	\$ 53,110	\$ 53,110	\$
Corporate bonds	188,574	932	(93)	189,413	17,704	171,709
Asset backed securities	33,655	23	(1)	33,677	25,669	8,008
Market basis equity investments	4,147		(324)	3,823		3,823
Student loan bonds	86,575		(6,586)	79,989		79,989
Total available-for-sale securities	\$ 366,015	\$ 1,013	\$ (7,016)	\$ 360,012	\$ 96,483	\$ 263,529
Balance as of December 31, 2010						
Certificates of deposit	\$ 93	\$	\$	\$ 93	\$ 93	\$
U.S. government sponsored entities	35,021	2	(58)	34,965	34,965	
Corporate bonds	122,132	97	(285)	121,944	8,330	113,614
Asset backed securities	6,033		(6)	6,027	6,027	
Market basis equity investments	3,818			3,818		3,818
Student loan bonds	90,600		(6,922)	83,678		83,678
Total available-for-sale securities	\$ 257,697	\$ 99	\$ (7,271)	\$ 250,525	\$ 49,415	\$ 201,110

We consider the fair value decline of our investments in U.S. government sponsored entities and asset backed 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 student loan bonds.

Realized gains or losses on investments are recorded in our statement of operations within Other expense, net. In the three months ended June 30, 2011 and 2010, the Company's proceeds on sales of investments equaled par value. Upon the sale of a security classified as available for sale, the security's specific unrealized gain (loss) is reclassified out of Accumulated other comprehensive income (loss) into earnings. In the three months ended June 30, 2011 and 2010, the Company reclassified from Accumulated other comprehensive income (loss) to net assets \$0.01 million and \$0.3 million, respectively, related to securities settled at par within the periods. In the six months ended June 30, 2011 and 2010, the Company reclassified from Accumulated other comprehensive income (loss) to net assets \$0.1 million and \$0.3 million, respectively, related to securities settled at par within the periods. Realized gains and losses on sales of investments were immaterial in the three and six months ended June 30, 2011 and 2010.

5. BUSINESS COMBINATIONS, GOODWILL AND INTANGIBLE ASSETS**Business Combinations****Acquisitions completed in 2011**

During the six months ended June 30, 2011, we did not complete any acquisitions.

Acquisitions completed in 2010

In 2010, we completed two acquisitions for a total purchase price of \$29.4 million. The purchase price for the Journey Education Marketing, Inc. asset acquisition, previously disclosed as preliminary, was finalized during the current quarter. This asset purchase consisted of \$7.0 million cash consideration and \$15.4 million of net liabilities assumed.

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The final purchase price for Journey Education Marketing, Inc. asset acquisition has been allocated to assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The allocation of the purchase price is summarized in the following table:

Acquisition	Initial Cash Consideration	Acquired Assets	Assumed Liabilities	Goodwill	Other Intangible Assets		
					Technology/ Tradename	Customer Relationships	Non-compet Agreements
Journey Education Marketing, Inc.	\$ 7,000	\$ 8,654	\$ (24,020)	\$ 9,832	\$ 3,693	\$ 6,854	\$ 1,987

Table of Contents**Accrued Acquisition Liabilities**

As of June 30, 2011, there we no estimated future earn-outs or additional consideration in accrued acquisition liabilities. During the three and six months ended June 30, 2011, we recorded a reduction to operating expenses of \$0.7 million relating to amounts previously accrued. As of December 31, 2010, there were estimated future earn-outs and additional consideration of \$1.6 million in accrued acquisition liabilities.

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,	
	2011	2010	2011	2010
Costs and expenses				
Direct cost of services	\$ 118	\$ 161	\$ 233	\$ 299
Network and infrastructure	345	270	592	468
Sales and marketing	2,116	1,876	3,876	3,249
Product research and development	781	908	1,491	1,633
General and administrative	2,371	2,307	4,494	4,349
Stock-based compensation included in costs and expenses	\$ 5,731	\$ 5,522	\$ 10,686	\$ 9,998

7. INCOME TAXES

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Current tax expense (benefit):				
United States	\$ (1,120)	\$ (2,357)	\$ 42	\$ (188)
International	969	(50)	1,673	490
Total current provision for income taxes	\$ (151)	\$ (2,407)	\$ 1,715	\$ 302
Tax Rate	-108.2%	49.2%	19.0%	6.3%

There is uncertainty of future realization of the deferred tax assets resulting from tax loss carryforwards due to anticipated limitations. Therefore, a valuation allowance was recorded against the tax effect of such tax loss carryforwards. At June 30, 2011, the Company has a valuation allowance on approximately \$0.5 million of deferred tax assets related to operating losses and \$0.3 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. Any future release of this valuation allowance will reduce expense.

As of June 30, 2011, we had \$10.2 million of unrecognized tax benefits, excluding related interest. All of these unrecognized tax benefits would affect our effective tax rate if recognized. Gross unrecognized tax benefits increased by \$0.1 million during the quarter for items identified during the current period. As of June 30, 2011, we had approximately \$0.6 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 \$2.8 million.

8. CONTINGENCIES

Litigation

DDR Holdings, LLC (DDR Holdings) has brought a claim against us and several other defendants regarding U.S. Patents No. 6,629,135 (the 135 patent) and 6,993,572 (the 572 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. The complaint seeks injunctive relief, declaratory relief, damages and attorneys fees. We have denied infringement of any valid claim of the patents-in-suit, and have asserted counter-claims which seek a judicial declaration that the patents are invalid and not infringed. In September 2006, DDR Holdings filed an application for

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reexamination of its patents based upon the prior art produced by us and the other defendants in the case. As part of that application, DDR Holdings asserted that this prior art raised a substantial question as to the patentability of the inventions claimed in the patents. In December 2006, the Court stayed the litigation pending a decision on the reexamination application. In February 2007, the U.S. Patent and Trademark Office ordered reexamination of DDR Holdings' patents.

On January 5, 2009, the U.S. Patent and Trademark Office issued a final office action rejecting the claims in the 135 patent which were subject to reexamination. On January 14, 2009, the U.S. Patent and Trademark Office issued a final office action rejecting all but two of the claims in the 572 patent which were subject to reexamination. On April 16, 2010, the Board of Patent Appeals and Interferences reversed the decision of the Examiner to reject the claims in the 135 patent and the 572 patent which were subject to reexamination. On July 20, 2010, the U.S. Patent and Trademark Office issued Reexamination Certificates for the 135 and 572 patents with no changes to the asserted patent claims. On October 4, 2010, the Court granted DDR Holdings' unopposed motion to lift the stay in the Texas litigation. On December 8, 2010, DDR filed a third amended complaint adding claims of infringement related to a more recently issued patent. On February 14, 2011, Digital River filed its answer to the third amended complaint. The parties are engaged in discovery and have exchanged claim charts. We intend to vigorously defend ourselves in the DDR Holdings matters, however, given the relatively early stage of the proceedings, no assurances can be given at this time as to the ultimate outcome of this case, or the range of potential loss should the outcome be unfavorable.

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.

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 the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are 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.

Table of Contents***Commitments and Guarantees***

At certain times, we enter into contracts with counterparties that commit the company to future obligations. During the second quarter of 2011, we entered into a letter of credit agreement which allows our credit card processors to draw up to \$3.0 million from an executor bank. 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. The letter of credit is valid through the second quarter of 2012. As of June 30, 2011, we have not drawn on our letter of credit. No other letters of credit were outstanding as of June 30, 2011 and December 31, 2010.

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 100% of their 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 with their terms, on November 1, 2030.

Holder 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 \$345 million in aggregate principal amount, the 2010 Notes may be converted into approximately 7,022,027 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 100% of the principal amount of the 2010 Notes to be redeemed, plus accrued and unpaid interest to, but excluding, the redemption date.

Holder 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 100% of 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 100% of the principal amount of the 2010 Notes being repurchased, plus accrued and unpaid interest to, but excluding, the repurchase date.

Proceeds from the 2010 Note were used to fund a \$35.0 million common stock repurchase buy-back program completed in 2010 and the remainder of the net proceeds from the sale will be used for general corporate and strategic purposes.

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 100% of their principal amount. On January 5, 2009, we announced that holders of 95.5% of the 2004 Notes exercised the option to require us to repurchase those Notes on January 2, 2009, at a purchase price of 100.25% of the principal amount of each tendered 2004 Note. 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. 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

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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.

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.

Overview

We provide end-to-end global e-commerce 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 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 e-commerce store and/or shopping cart operated by us on our e-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 e-commerce and marketing platforms, including business-to-business 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 e-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.

On September 1, 2010, we announced an amendment of our agreement with Microsoft Corporation (Microsoft) to extend the term of the Microsoft Operations Digital Distribution Agreement through October 31, 2013. On August 30, 2010, we entered into the Microsoft Store USA statement of work with Microsoft whereby we will build, host and manage 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 in the United States. On March 2, 2011, Digital River began providing e-commerce hosting and payment processing services in connection with Microsoft Store. In addition to Microsoft Store, Digital River maintains its role as a reseller of Microsoft products via Digital River's existing online stores. Currently, we are providing e-commerce services, ranging from transaction and payment processing, to e-marketing, digital downloads, fraud prevention and multi-lingual customer support in support of some of the popular Microsoft software titles, including Microsoft® Office. The global arrangement incorporates digital fulfillment across multiple geographies, including North America, Asia, Europe and Latin America.

As announced on October 12, 2009, Symantec Corporation informed us that it elected not to renew its e-commerce agreement with us. As a consequence, their e-commerce agreement terminated on June 30, 2010.

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

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We were incorporated in Delaware in February 1994. Our headquarters are located at 9625 West 76th Street, Eden Prairie, 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

The following table sets forth certain items from our consolidated statements of operations as a percentage of total revenue for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenue	100.0%			