

DIGITAL RIVER INC /DE  
Form 10-Q  
November 09, 2006

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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED September 30, 2006  
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)**

**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 is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Exchange Act Rule 12b-2)

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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 November 1, 2006 was 40,190,834 shares.

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**DIGITAL RIVER, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

|                                                                             | (Unaudited)<br>September<br>30,<br>2006 | December<br>31,<br>2005 |
|-----------------------------------------------------------------------------|-----------------------------------------|-------------------------|
| <b>ASSETS</b>                                                               |                                         |                         |
| <b>CURRENT ASSETS:</b>                                                      |                                         |                         |
| Cash and cash equivalents                                                   | \$ 335,676                              | \$ 131,770              |
| Short-term investments                                                      | 240,643                                 | 220,569                 |
| Accounts receivable, net of allowance of \$1,522 and \$1,023                | 39,698                                  | 34,883                  |
| Deferred income taxes                                                       | 13,068                                  | 22,251                  |
| Prepaid expenses and other                                                  | 5,380                                   | 3,741                   |
| Total current assets                                                        | 634,465                                 | 413,214                 |
| Property and equipment, net                                                 | 24,127                                  | 17,955                  |
| Goodwill                                                                    | 238,305                                 | 195,299                 |
| Intangible assets, net of accumulated amortization of \$46,627 and \$36,798 | 23,222                                  | 20,054                  |
| Deferred income taxes                                                       | 4,132                                   | 10,444                  |
| Other assets                                                                | 11,912                                  | 12,174                  |
| <b>TOTAL ASSETS</b>                                                         | <b>\$ 936,163</b>                       | <b>\$ 669,140</b>       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                 |                                         |                         |
| <b>CURRENT LIABILITIES:</b>                                                 |                                         |                         |
| Accounts payable                                                            | \$ 128,082                              | \$ 127,846              |
| Accrued payroll                                                             | 12,848                                  | 8,866                   |
| Deferred revenue                                                            | 7,012                                   | 5,403                   |
| Accrued acquisition costs                                                   | 6,004                                   | 5,651                   |
| Other accrued liabilities                                                   | 28,097                                  | 21,210                  |
| Total current liabilities                                                   | 182,043                                 | 168,976                 |
| <b>NON-CURRENT LIABILITIES:</b>                                             |                                         |                         |
| Convertible senior notes                                                    | 195,000                                 | 195,000                 |
| Deferred income taxes                                                       |                                         | 22                      |
| Total non-current liabilities                                               | 195,000                                 | 195,022                 |
| <b>TOTAL LIABILITIES</b>                                                    | <b>377,043</b>                          | <b>363,998</b>          |

COMMITMENTS AND CONTINGENCIES

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; 39,831,844 and 35,033,741 shares issued and outstanding

|                                               |         |         |
|-----------------------------------------------|---------|---------|
|                                               | 398     | 350     |
| Additional paid-in capital                    | 513,718 | 315,489 |
| Deferred compensation                         |         | (1,942) |
| Retained earnings/(accumulated deficit)       | 38,128  | (6,324) |
| Accumulated other comprehensive income (loss) | 6,876   | (2,431) |

|                            |         |         |
|----------------------------|---------|---------|
| Total stockholders' equity | 559,120 | 305,142 |
|----------------------------|---------|---------|

|                                            |            |            |
|--------------------------------------------|------------|------------|
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 936,163 | \$ 669,140 |
|--------------------------------------------|------------|------------|

See accompanying notes to condensed consolidated financial statements.

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**DIGITAL RIVER, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data; unaudited)

|                                                 | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|-------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                                                 | <b>2006</b>                                 | <b>2005</b> | <b>2006</b>                                | <b>2005</b> |
| Revenue                                         | \$ 75,337                                   | \$ 53,179   | \$ 224,628                                 | \$ 158,851  |
| Costs and expenses:                             |                                             |             |                                            |             |
| Direct cost of services                         | 1,912                                       | 1,050       | 5,689                                      | 3,538       |
| Network and infrastructure                      | 7,761                                       | 4,983       | 21,502                                     | 14,199      |
| Sales and marketing                             | 28,451                                      | 16,713      | 83,018                                     | 48,829      |
| Product research and development                | 8,338                                       | 5,210       | 23,428                                     | 14,796      |
| General and administrative                      | 8,054                                       | 5,294       | 24,551                                     | 16,210      |
| Depreciation and amortization                   | 2,943                                       | 2,308       | 7,671                                      | 6,805       |
| Amortization of acquisition-related intangibles | 3,313                                       | 2,089       | 9,191                                      | 6,595       |
| Total costs and expenses                        | 60,772                                      | 37,647      | 175,050                                    | 110,972     |
| Income from operations                          | 14,565                                      | 15,532      | 49,578                                     | 47,879      |
| Other income, net                               | 5,804                                       | 1,526       | 15,131                                     | 3,572       |
| Income before income tax expense                | 20,369                                      | 17,058      | 64,709                                     | 51,451      |
| Income tax expense                              | 5,581                                       | 4,700       | 20,255                                     | 14,830      |
| Net income                                      | \$ 14,788                                   | \$ 12,358   | \$ 44,454                                  | \$ 36,621   |
| Net income per share    basic                   | \$   0.37                                   | \$   0.35   | \$   1.17                                  | \$   1.07   |
| Net income per share    diluted                 | \$   0.33                                   | \$   0.31   | \$   1.04                                  | \$   0.92   |
| Shares used in per-share calculation    basic   | 39,619                                      | 34,824      | 38,126                                     | 34,342      |
| Shares used in per-share calculation    diluted | 45,666                                      | 41,972      | 44,107                                     | 41,558      |

See accompanying notes to condensed consolidated financial statements.

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**DIGITAL RIVER, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands; unaudited)

|                                                                                             | <b>Nine Months Ended<br/>September 30,</b> |                |
|---------------------------------------------------------------------------------------------|--------------------------------------------|----------------|
|                                                                                             | <b>2006</b>                                | <b>2005</b>    |
| <b>OPERATING ACTIVITIES:</b>                                                                |                                            |                |
| Net income                                                                                  | \$ 44,454                                  | \$ 36,621      |
| Adjustments to reconcile net income to net cash provided by operating activities:           |                                            |                |
| Amortization of acquisition-related intangibles                                             | 9,191                                      | 6,595          |
| Change in accounts receivable allowance, net of acquisitions                                | 426                                        | (257)          |
| Depreciation and amortization                                                               | 7,671                                      | 6,715          |
| Stock-based compensation expense related to stock options and employee stock purchase plans | 10,388                                     |                |
| Tax benefit of stock-based compensation                                                     |                                            | 10,496         |
| Excess tax benefits from stock-based compensation                                           | (3,032)                                    |                |
| Deferred and other income taxes                                                             | 17,676                                     | 3,030          |
| Change in operating assets and liabilities (net of acquisitions):                           |                                            |                |
| Accounts receivable                                                                         | (2,351)                                    | (2,431)        |
| Prepaid and other assets                                                                    | (291)                                      | (987)          |
| Accounts payable                                                                            | (7,028)                                    | 499            |
| Deferred revenue                                                                            | 881                                        | 527            |
| Income tax payable                                                                          | 1,022                                      | 4,064          |
| Accrued payroll and other accrued liabilities                                               | 5,680                                      | (569)          |
| Net cash provided by operating activities                                                   | 84,687                                     | 64,303         |
| <b>INVESTING ACTIVITIES:</b>                                                                |                                            |                |
| Purchases of investments                                                                    | (135,911)                                  | (144,509)      |
| Sales of investments                                                                        | 116,446                                    | 97,427         |
| Cash paid for acquisitions, net of cash received                                            | (37,998)                                   | (9,482)        |
| Purchases of equipment and capitalized software                                             | (12,825)                                   | (7,318)        |
| Net cash used in investing activities                                                       | (70,288)                                   | (63,882)       |
| <b>FINANCING ACTIVITIES:</b>                                                                |                                            |                |
| Proceeds from sales of common stock                                                         | 172,700                                    |                |
| Exercise of stock options                                                                   | 10,579                                     | 22,154         |
| Sales of common stock under employee stock purchase plan                                    | 933                                        | 1,488          |
| Repurchase of common stock                                                                  |                                            | (3,205)        |
| Excess tax benefits from stock-based compensation                                           | 3,032                                      |                |
| Net cash provided by financing activities                                                   | 187,244                                    | 20,437         |
| <b>EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>                                              | <b>2,263</b>                               | <b>(3,524)</b> |

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|                                                    |            |            |
|----------------------------------------------------|------------|------------|
| NET INCREASE IN CASH AND CASH EQUIVALENTS          | 203,906    | 17,334     |
| CASH AND CASH EQUIVALENTS, beginning of period     | 131,770    | 127,734    |
| CASH AND CASH EQUIVALENTS, end of period           | \$ 335,676 | \$ 145,068 |
| SUPPLEMENTAL DISCLOSURES:                          |            |            |
| Cash paid for interest on Convertible Senior Notes | \$ 2,438   | \$ 2,641   |
| Cash paid for income taxes                         | \$ 1,424   | \$         |
| Noncash investing and financing activities:        |            |            |
| Common stock issued in acquisitions and earn-outs  | \$ 488     | \$         |

See accompanying notes to condensed consolidated financial statements.



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**DIGITAL RIVER, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**1. BASIS OF PRESENTATION**

The unaudited condensed 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 condensed 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, 2005 as filed with the Securities and Exchange Commission. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2006. The December 31, 2005 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles 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, 2005.

***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 into U.S. dollars at average exchange rates for the period. Gains and losses resulting from translation are recorded as a component of equity. Gains and losses resulting from foreign currency transactions are recognized as other income, net.

***Research and Development and Software Development***

Research and development expenses consist primarily of development personnel and non-employee contractor costs related to the development of new products and services, enhancement of existing products and services, quality assurance, and testing. Costs to develop software for internal use are required to be capitalized and amortized over the estimated useful life of the software in accordance with AICPA Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. During the three months ended September 30, 2006 and 2005, we did not capitalize any software development costs. During the nine months ended September 30, 2006 and 2005, we capitalized \$0 and \$0.4 million, respectively, of software development costs.

***Stock-Based Compensation Expense***

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, ( SFAS 123(R) ) which requires the measurement and recognition of compensation expense for all share-based payments made to employees and directors including stock options, restricted stock grants and employee stock purchases made through our Employee Stock Purchase Plan based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees, for periods beginning in 2006.

Prior to the adoption of SFAS 123(R), we had elected to apply the disclosure-only provision of SFAS No. 123,

Accounting for Stock-Based Compensation as amended by SFAS No. 148. Accordingly, we accounted for stock-based compensation using the intrinsic value method prescribed in APB 25 and related interpretations. Compensation expense for stock options was measured as the excess, if any, of the fair value of our common stock at the date of grant over the stock option exercise price and we generally recognized no compensation expense for employee stock options.

We have adopted SFAS 123(R) using the modified prospective transition method under which prior periods are not revised.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based awards that are ultimately expected to vest during the period. Stock-based compensation expense recognized in our Condensed Consolidated Statement of Operations for 2006 includes compensation expense for share-based awards granted prior to, but not yet vested, as of December 31, 2005 as well as



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compensation expense for the share-based payment awards granted subsequent to December 31, 2005. The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option pricing model. The fair value of restricted stock is determined based on the number of shares granted and the closing price of our common stock on the date of grant. Compensation expense for all share-based payment awards are recognized using the straight-line amortization method over the vesting period. As stock-based compensation expense recognized in our Condensed Consolidated Statement of Operations for 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Our pro forma information required under SFAS 123, for periods prior to 2006, accounted for forfeitures as they occurred.

SFAS 123(R) also requires the benefits of tax deductions in excess of recognized stock-based compensation expense be reported as a financing cash flow, rather than an operating cash flow as required prior to adoption of SFAS 123(R) in our Condensed Consolidated Statement of Cash Flows.

See Note 4 for further information regarding our stock-based compensation plans, condensed consolidated statement of operations classification of stock-based compensation expense, pro forma net earnings and net earnings per share for the third quarter of 2005 as if we had recorded stock-based compensation expense under the fair value method and assumptions used to measure stock-based compensation.

***Recent Accounting Pronouncement***

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). To reduce diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. We do not believe SAB 108 will have a material impact on our results from operations or financial position.

In July 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting and disclosure for uncertainty in tax positions. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. This interpretation is effective for fiscal years beginning after December 15, 2006. We will adopt FIN 48 as of January 1, 2007, as required. The cumulative effect of adopting FIN 48 will be recorded in retained earnings and other accounts as applicable. We have not yet determined the impact, if any, this interpretation will have on our results from operations or financial position.

**2. NET INCOME PER SHARE**

Basic income per common share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share is calculated by dividing net income, adjusted to exclude interest expense and financing cost amortization related to potentially dilutive securities, by the weighted average number of common shares outstanding during the period, plus any additional common shares that would have been outstanding if potentially dilutive common shares had been issued during the period.

Our diluted earnings per common share calculation includes the dilutive impact of notes that are contingently convertible into approximately 4.4 million shares of common stock at a conversion price of \$44.063 per share. See Note 6 for further information regarding our convertible senior notes.

Statement of Financial Accounting Standards No. 128, Earnings per Share, requires that stock options, restricted stock grants and similar equity instruments granted be treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options which are calculated based on the average share price for each period using the treasury stock method. Under the treasury stock method, the amount the optionee must pay for exercising stock options, the amount of compensation cost for future service that we have not yet recognized, and the amount of benefits that would be recorded in additional paid-



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in capital when the award becomes deductible are assumed to be used to repurchase shares. Prior to the removal of the valuation allowance on our deferred taxes in the fourth quarter of 2005, the amount of benefits that would be recorded in additional paid-in capital was not included in our computation of diluted earnings per share.

The table below sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

|                                                                                                           | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|-----------------------------------------------------------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                                                                                                           | <b>2006</b>                                 | <b>2005</b> | <b>2006</b>                                | <b>2005</b> |
| Earnings per share    basic                                                                               |                                             |             |                                            |             |
| Net income    basic                                                                                       | \$ 14,788                                   | \$ 12,358   | \$ 44,454                                  | \$ 36,621   |
| Weighted average shares outstanding    basic                                                              | 39,619                                      | 34,824      | 38,126                                     | 34,342      |
| Earnings per share    basic                                                                               | \$ 0.37                                     | \$ 0.35     | \$ 1.17                                    | \$ 1.07     |
| Earnings per share    diluted                                                                             |                                             |             |                                            |             |
| Net income    basic                                                                                       | 14,788                                      | 12,358      | 44,454                                     | 36,621      |
| Exclude: Interest expense and amortized financing cost<br>of convertible senior notes, net of tax benefit | 435                                         | 501         | 1,305                                      | 1,470       |
| Net income    diluted                                                                                     | \$ 15,223                                   | \$ 12,859   | \$ 45,759                                  | \$ 38,091   |
| Weighted average shares outstanding    basic                                                              | 39,619                                      | 34,824      | 38,126                                     | 34,342      |
| Dilutive impact of non-vested stock and options<br>outstanding                                            | 1,622                                       | 2,723       | 1,556                                      | 2,791       |
| Dilutive impact of convertible senior notes                                                               | 4,425                                       | 4,425       | 4,425                                      | 4,425       |
| Weighted average shares outstanding    diluted                                                            | 45,666                                      | 41,972      | 44,107                                     | 41,558      |
| Net income per share    diluted                                                                           | \$ 0.33                                     | \$ 0.31     | \$ 1.04                                    | \$ 0.92     |

### **3. BUSINESS COMBINATIONS, GOODWILL AND INTANGIBLE ASSETS**

In June 2006, we acquired all of the capital stock of MindVision, Inc. (MindVision), a privately held e-commerce company based in Lincoln, Nebraska, for approximately \$25.0 million comprised of payments to stockholders of \$21.2 million plus the assumption of approximately \$3.7 million in liabilities. The allocation of the purchase price of MindVision will be finalized upon completion of the analysis of the fair value of MindVision's assets. The result of the allocation of the purchase price between amortizable costs and goodwill could have an impact on our future operating results.

In January 2006, we acquired all of the capital stock of Direct Response Technologies, Inc. (Direct Response), a privately held company based in Pittsburgh, Pennsylvania, for approximately \$15.0 million in cash. Direct Response, a provider of tools for managing affiliate networks, is now named DR Marketing Solutions, Inc. The agreement also provides Direct Response shareholders with an earn-out opportunity based on Digital River and DR Marketing Solutions, Inc. achieving certain revenue and earnings targets during the first three years subsequent to the acquisition. In the second quarter of 2006, we accrued \$4.0 million for future earn-out payments. The allocation of the purchase price of Direct Response will be finalized upon completion of the analysis of the fair value of Direct Response's assets.

The result of the allocation of the purchase price between amortizable costs and goodwill could have an impact on our future operating results.

In December 2005, we acquired all of the capital stock of Commerce5, Inc. (Commerce5) for approximately \$45.1 million in cash comprised of payments to stockholders of \$32.4 million plus payments of \$12.7 million in liabilities. Commerce5, now named DR globalTech, Inc., is an outsourced e-commerce provider to high-tech and consumer electronics manufacturers headquartered in Aliso Viejo, California. The allocation of the purchase price of Commerce5 will be finalized upon completion of the analysis of the fair value of Commerce5's assets. The result of the allocation of the purchase price between amortizable costs and goodwill could have an impact on our future operating results.

In March 2005, we acquired certain assets and assumed certain liabilities, vendor contracts and intellectual property of SWReg, an operating business of Atlantic Coast plc, a private limited UK company, for \$8.8 million in cash. SWReg is a provider of e-commerce services for software authors. We also may make additional earn-out payments in cash based on achieving specific revenue and development goals over the first 12 months following the closing of the acquisition. As of September 30, 2006, earn-outs totaling \$0.5 million have been recorded as goodwill as they were considered incremental to the purchase price. The \$0.5 million was paid in the second quarter of 2006.

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**DIGITAL RIVER, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

In April 2004, we acquired element 5 AG (element 5), a privately held company based in Germany and a leading European e-commerce solution provider for software publishers. Element 5 is now named Digital River GmbH. Under the terms of the acquisition, we paid \$120 million in cash to acquire all of the outstanding shares of capital stock of element 5. We also agreed to pay up to an additional \$2.5 million in cash based on element 5's operating performance over the first 24 months following the closing of the acquisition.

On January 18, 2005, we entered into an agreement with senior employees of element 5, pursuant to which these employees agreed to cease providing services to element 5 sixty days after the date of the agreement. Pursuant to the agreement, we also agreed to resolve a \$12 million escrow associated with our acquisition of element 5 by distributing \$10 million to the former element 5 shareholders, and \$2 million to us. Certain adjustments also were made to our earn-out obligations under the April 2004 acquisition agreement. These earn-out amounts have been recorded as additional goodwill as they were incremental to the purchase price.

We have recorded a net of \$5.4 million as part of the acquisition cost of element 5 related to these acquisition restructuring plans of which \$530,000 remained unpaid as of September 30, 2006. The following table provides detail on the activity and our remaining accrual balance by category as of September 30, 2006 (in thousands):

|                          | Accrual<br>April<br>16,<br>2004 |           |         | Accrual<br>December<br>31, 2004 |           |           | Adjust-<br>ments |           | Charges   |     | Accrual<br>December<br>31, 2005 |           | Charges |           | Accrual<br>September<br>30,<br>2006 |     |
|--------------------------|---------------------------------|-----------|---------|---------------------------------|-----------|-----------|------------------|-----------|-----------|-----|---------------------------------|-----------|---------|-----------|-------------------------------------|-----|
|                          | Net                             | Additions | Charges | Net                             | Additions | Charges   | Net              | Additions | Charges   | Net | Additions                       | Charges   | Net     | Additions | Charges                             | Net |
| Shareholder escrow       | \$                              | \$2,500   | \$      | \$2,500                         | \$        | \$(1,250) | \$               | \$1,250   | \$(1,250) | \$  | \$1,250                         | \$(1,250) | \$      | \$1,250   | \$(1,250)                           | \$  |
| Employee severance costs | 700                             | 2,100     | (400)   | 2,400                           | (200)     | (1,250)   | 950              | (420)     | 530       |     |                                 |           |         |           |                                     |     |
| Facilities consolidation | 200                             | 100       | (300)   |                                 |           |           |                  |           |           |     |                                 |           |         |           |                                     |     |
| Total                    | \$900                           | \$4,700   | \$(700) | \$4,900                         | \$(200)   | \$(2,500) | \$2,200          | \$(1,670) | \$530     |     |                                 |           |         |           |                                     |     |

Related to all acquisitions as of September 30, 2006, there was an estimated potential for future earn-outs of approximately \$4.4 million in excess of the \$4.9 million in earn-outs included in accrued acquisition costs. Any of the estimated maximum potential future earn-out beyond the \$4.9 million accrual will result in additional goodwill.

The Condensed Consolidated Financial Statements include the operating results of each business from the date of acquisition. The following unaudited pro forma condensed results of operations for the three and nine months ended September 30, 2006 and 2005 have been prepared as if each of the acquisitions had occurred on January 1, 2005 (in thousands, except per share amounts):

|                            | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|----------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                            | 2006                                | 2005     | 2006                               | 2005      |
| Revenue                    | \$75,337                            | \$58,712 | \$228,086                          | \$174,839 |
| Income from operations     | 14,565                              | 14,963   | 49,196                             | 45,260    |
| Net income                 | 14,788                              | 11,214   | 43,852                             | 33,911    |
| Basic net income per share | \$ 0.37                             | \$ 0.32  | \$ 1.15                            | \$ 0.99   |

|                              |         |         |         |         |
|------------------------------|---------|---------|---------|---------|
| Diluted net income per share | \$ 0.33 | \$ 0.28 | \$ 1.02 | \$ 0.84 |
|------------------------------|---------|---------|---------|---------|

This financial information does not purport to represent results that would actually have been obtained if the transactions had been completed on January 1, 2005 or any future results that may be realized.

***Goodwill and Other Intangible Assets***

We account for our goodwill in accordance with SFAS No. 142, Goodwill and Other Intangible Asset. SFAS No. 142 precludes the amortization of goodwill and intangible assets with indefinite lives, but these assets are reviewed annually (or more frequently if impairment indicators arise) for impairment.



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We complete our annual impairment test in the fourth quarter of each fiscal year, and reassess any intangible assets, including goodwill, recorded in connection with earlier acquisitions. There was no impairment of goodwill or other intangible assets in the three and nine months ended September 30, 2006 and 2005.

Information regarding our other intangible assets is as follows (in thousands):

|                        | <b>As of September 30, 2006</b>      |                                     |                                    |
|------------------------|--------------------------------------|-------------------------------------|------------------------------------|
|                        | <b>Carrying<br/>Amount<br/>Gross</b> | <b>Accumulated<br/>Amortization</b> | <b>Carrying<br/>Amount<br/>Net</b> |
| Customer relationships | \$ 41,752                            | \$ 27,842                           | \$ 13,910                          |
| Non-compete agreements | 5,868                                | 4,935                               | 933                                |
| Technology/tradename   | 22,229                               | 13,850                              | 8,379                              |
| Total                  | \$ 69,849                            | \$ 46,627                           | \$ 23,222                          |

|                        | <b>As of December 31, 2005</b>       |                                     |                                    |
|------------------------|--------------------------------------|-------------------------------------|------------------------------------|
|                        | <b>Carrying<br/>Amount<br/>Gross</b> | <b>Accumulated<br/>Amortization</b> | <b>Carrying<br/>Amount<br/>Net</b> |
| Customer relationships | \$ 34,666                            | \$ 21,103                           | \$ 13,563                          |
| Non-compete agreements | 5,121                                | 4,300                               | 821                                |
| Technology/tradename   | 17,065                               | 11,395                              | 5,670                              |
| Total                  | \$ 56,852                            | \$ 36,798                           | \$ 20,054                          |

Amortization expense for the three months ended September 30, 2006 and 2005 was \$3.3 million and \$2.1 million, respectively and \$9.2 million and \$6.6 million for the nine months ended September 30, 2006 and 2005 respectively. Estimated amortization expense for the remaining life of the intangible assets, based on intangible assets as of September 30, 2006, is as follows (in thousands):

|       |           |
|-------|-----------|
| Year  |           |
| 2006  | 3,121     |
| 2007  | 8,233     |
| 2008  | 5,708     |
| 2009  | 4,762     |
| 2010  | 1,002     |
| 2011  | 396       |
| Total | \$ 23,222 |

#### **4. STOCK-BASED COMPENSATION PLANS**

##### ***Option and Restricted Stock Awards***

Prior to the annual stockholders' meeting held in May 2005, we had two stock-based employee compensation plans. At the annual stockholders' meeting held in May 2005, our stockholders approved an amendment and restatement of our 1998 Stock Option Plan that combined the 1998 Plan with our 1999 Stock Option Plan and gave us the flexibility

to grant restricted stock awards, restricted stock unit awards and performance shares, in addition to incentive and nonstatutory stock options, to our directors, employees, and consultants under the combined plan. We call our new amended and restated plan our 1998 Equity Incentive Plan (the "1998 Plan").

As of September 30, 2006, there were 1,554,368 shares available for future awards under our 1998 Plan. The number of shares available has been reduced by three shares for every two shares granted under the stock award plan that does not provide for full payment by the participant.

Options granted to employees typically expire no later than ten years after the date of grant. Incentive stock option grants must have an exercise price of at least 100% of the fair market value of a share of common stock on the grant date. Incentive stock options granted to employees who, immediately before such grant, owned stock directly or indirectly representing more than 10% of the voting power of our

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stock will have an exercise price of 110% of the fair market value of a share of common stock on the grant date and will expire no later than five years from the date of grant. The 1998 Plan also provides for other stock-based awards as may be established by the Board of Directors or the Compensation Committee.

A summary of the changes in outstanding options under the 1998 Plan is as follows:

|                                                       | <b>Shares<br/>Available<br/><br/>for Grant</b> | <b>Options<br/><br/>Outstanding</b> | <b>Options<br/>Price<br/><br/>Per Share</b> | <b>Weighted<br/>Average<br/>Price<br/>Per<br/>Share</b> |
|-------------------------------------------------------|------------------------------------------------|-------------------------------------|---------------------------------------------|---------------------------------------------------------|
| Balance, December 31, 2004                            | 2,456,343                                      | 5,714,740                           | \$ 1.69 - \$31.13                           | \$ 13.94                                                |
| Granted                                               | (846,678)                                      | 846,678                             | 23.90 - 30.69                               | 28.15                                                   |
| Exercised                                             |                                                | (1,719,114)                         | 1.69 - 30.69                                | 13.50                                                   |
| Canceled/expired                                      | 318,919                                        | (318,919)                           | 3.88 - 27.40                                | 15.15                                                   |
| Balance, December 31, 2005                            | 1,928,584                                      | 4,523,385                           | 2.59 - 31.13                                | 16.69                                                   |
| Granted                                               | (359,000)                                      | 359,000                             | 29.75 - 48.39                               | 37.05                                                   |
| Restricted stock effect on shares available for grant | (128,250)                                      | N/A                                 | N/A                                         | N/A                                                     |
| Exercised                                             |                                                | (624,155)                           | 2.59 - 31.13                                | 16.95                                                   |
| Canceled/expired                                      | 113,034                                        | (113,034)                           | 2.59 - 27.40                                | 22.06                                                   |
| Balance, September 30, 2006                           | 1,554,368                                      | 4,145,196                           | \$ 2.59 - \$48.39                           | \$ 18.27                                                |

The total pretax intrinsic value of options exercised during the nine months ended September 30, 2006 was \$14.9 million.

The following table summarizes significant ranges of outstanding and exercisable options under our 1998 Plan as of September 30, 2006:

| <b>Exercise Price</b> | <b>Number<br/>Outstanding</b> | <b>Options Outstanding</b>                     |                                       |                                          | <b>Number<br/>Exercisable</b> | <b>Options Exercisable</b>            |                                          |
|-----------------------|-------------------------------|------------------------------------------------|---------------------------------------|------------------------------------------|-------------------------------|---------------------------------------|------------------------------------------|
|                       |                               | <b>Weighted<br/>Average<br/>Life Remaining</b> | <b>Weighted<br/>Average<br/>Price</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |                               | <b>Weighted<br/>Average<br/>Price</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
| \$1.69 - \$3.88       | 134,746                       | 2.2 years                                      | \$ 3.04                               | \$ 6,479,162                             | 134,746                       | \$ 3.04                               | \$ 6,479,162                             |
| 4.56 - 7.55           | 924,144                       | 4.6 years                                      | 5.37                                  | 42,279,200                               | 922,491                       | 5.37                                  | 42,207,096                               |
| 9.12 - 13.92          | 826,554                       | 6.1 years                                      | 11.55                                 | 32,706,148                               | 631,627                       | 11.78                                 | 24,845,840                               |
| 16.72 - 22.98         | 812,171                       | 6.9 years                                      | 22.05                                 | 23,612,651                               | 556,752                       | 22.26                                 | 16,066,922                               |
| 23.01 - 31.13         | 1,140,581                     | 8.3 years                                      | 27.30                                 | 27,172,907                               | 324,011                       | 26.80                                 | 7,879,268                                |
| 31.14 - 48.40         | 307,000                       | 9.5 years                                      | 38.29                                 | 3,938,970                                | 27,811                        | 35.49                                 | 434,618                                  |
| \$1.69 - \$48.40      | 4,145,196                     | 6.6 years                                      | \$ 18.27                              | \$ 136,189,037                           | 2,597,438                     | \$ 13.42                              | \$ 97,912,907                            |

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on options with an exercise price less than the Company's closing stock price of \$51.12 as of September 30, 2006, which would have been received by the option holders had those option holders exercised their options as of that date.

A summary of the changes in restricted stock under our 1998 Plan as of September 30, 2006 is as follows:

|                                        | <b>Restricted<br/>Stock</b> | <b>Weighted<br/>Average<br/>Intrinsic<br/>Value</b> |
|----------------------------------------|-----------------------------|-----------------------------------------------------|
| Non-Vested Balance, December 31, 2005  |                             | \$                                                  |
| Granted                                | 85,500                      | 39.45                                               |
| Vested                                 |                             |                                                     |
| Forfeited                              |                             |                                                     |
| Non-Vested Balance, September 30, 2006 | 85,500                      | \$ 39.45                                            |

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***Employee Stock Purchase Plan***

We also sponsor an employee stock purchase plan under which 1,200,000 shares have been reserved for purchase by employees. The purchase price of the shares under the plan is the lesser of 85% of the fair market value on the first or last day of the offering period. Offering periods are currently every six months ending on June 30 and December 31. Employees may designate up to ten percent of their compensation for the purchase of shares under the plan. Total shares purchased by employees under the plan were 37,000 shares for the six months ended June 30, 2006, and 83,000 shares and 51,000 shares in the years ended December 31, 2005 and 2004, respectively. There were 591,119 shares still reserved under the plan as of September 30, 2006.

***Inducement Equity Incentive Plan***

Effective on December 14, 2005, in connection with our acquisition of Commerce5, Inc. (now DR globalTech), we adopted an Inducement Equity Incentive Plan (the "Inducement Plan") initially for Commerce5, Inc. executives who joined Digital River as a result of the acquisition, or other personnel who join us after the date of the Inducement Plan adoption. A total of 87,500 restricted shares of Digital River stock may be issued under the Inducement Plan, subject to vesting. In December 2005, we issued 63,750 shares under the Inducement Plan. In January 2006, we issued the remaining 23,750 shares. In accordance with the NASDAQ rules, no stockholder approval was required for the Inducement Plan.

***Expense Information under SFAS 123(R)***

On January 1, 2006, we adopted SFAS 123(R) which requires measurement and recognition of compensation expense for all stock-based payments made to employees and directors including stock options, restricted stock grants and employee stock purchases made through our Employee Stock Purchase Plan based on estimated fair values. The following table summarizes stock-based compensation expense, net of tax, related to employee stock options and employee stock purchases recognized under SFAS 123(R):

|                                                         | <b>Three Months Ended<br/>September 30,<br/>2006</b> |         | <b>September 30,<br/>2005</b> |         |
|---------------------------------------------------------|------------------------------------------------------|---------|-------------------------------|---------|
|                                                         |                                                      |         |                               |         |
| Costs and expenses                                      |                                                      |         |                               |         |
| Direct cost of services                                 | \$                                                   | 197     | \$                            | 629     |
| Network and infrastructure                              |                                                      | 78      |                               | 248     |
| Sales and marketing                                     |                                                      | 1,268   |                               | 3,880   |
| Product research and development                        |                                                      | 556     |                               | 1,732   |
| General and administrative                              |                                                      | 1,357   |                               | 3,899   |
| Stock-based compensation included in costs and expenses |                                                      | 3,456   |                               | 10,388  |
| Tax benefit                                             |                                                      | (1,286) |                               | (3,864) |
| Stock-based compensation expense, net of tax            | \$                                                   | 2,170   | \$                            | 6,524   |

The following table reflects net income and basic and diluted net income per share for the three and nine months ended September 30, 2006 compared with the pro forma information for the three and nine months ended September 30, 2005:

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**DIGITAL RIVER, INC.**  
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|                                                                                            | <b>Three Months Ended<br/>September 30,<br/>Pro<br/>forma</b> |             | <b>Nine Months Ended<br/>September 30,<br/>Pro<br/>forma</b> |             |
|--------------------------------------------------------------------------------------------|---------------------------------------------------------------|-------------|--------------------------------------------------------------|-------------|
|                                                                                            | <b>2006</b>                                                   | <b>2005</b> | <b>2006</b>                                                  | <b>2005</b> |
| Net income, as reported for prior periods (1)                                              | N/A                                                           | \$ 12,358   | N/A                                                          | \$ 36,621   |
| Stock-based compensation expense                                                           | \$ (3,456)                                                    | (3,347)     | \$ (10,388)                                                  | (6,581)     |
| Tax benefit (2)                                                                            | 1,286                                                         |             | 3,864                                                        |             |
| Stock-based compensation expense, net of tax (3)                                           | (2,170)                                                       | (3,347)     | (6,524)                                                      | (6,581)     |
| Net income, including the effect of stock-based compensation expense (4)                   | \$ 14,788                                                     | 9,011       | \$ 44,454                                                    | 30,040      |
| Basic net income per share as reported for prior periods (1)                               | N/A                                                           | \$ 0.30     | N/A                                                          | \$ 0.71     |
| Diluted net income per share as reported for prior periods (1)                             | N/A                                                           | \$ 0.26     | N/A                                                          | \$ 0.61     |
| Basic net income per share, including the effect of stock-based compensation expense (4)   | \$ 0.37                                                       | \$ 0.20     | \$ 1.17                                                      | \$ 0.52     |
| Diluted net income per share, including the effect of stock-based compensation expense (4) | \$ 0.33                                                       | \$ 0.18     | \$ 1.04                                                      | \$ 0.45     |

(1) Net income and net income per share prior to 2006 did not include stock-based compensation expense under SFAS 123 because we did not adopt the recognition provisions of SFAS 123.

(2) No tax benefit was recorded

prior to the removal of the valuation allowance on certain deferred tax assets in the fourth quarter of 2005.

- (3) Stock-based compensation expense prior to 2006 is calculated based on the pro forma application of SFAS 123.
- (4) Net income and net income per share prior to 2006 represents pro forma information based on SFAS 123.

***Valuation Information under SFAS 123(R)***

The weighted-average fair value of stock options granted during the nine months ended September 30, 2006 and 2005 were \$16.51 and \$15.28 per share, respectively, using the Black-Scholes option pricing model with the following weighted average assumptions:

|                         | <b>Nine Months Ended<br/>September 30,</b> |             |
|-------------------------|--------------------------------------------|-------------|
|                         | <b>2006</b>                                | <b>2005</b> |
| Risk-free interest rate | 4.7%                                       | 4.0%        |
| Expected life (years)   | 4.2                                        | 4.0         |
| Volatility factor       | 0.60                                       | 0.93        |
| Expected dividends      |                                            |             |

The risk-free interest rate assumption is based on observed interest rates appropriate for the term of our stock options. The expected life of stock options represents the weighted-average period the stock options are expected to remain outstanding and is based on historical exercise patterns. We used historical closing stock price volatility for a period equal to the expected term of the options granted. The dividend yield assumption is based on our history and expectation of future dividend payouts.

As stock-based compensation expense recognized in the Condensed Consolidated Statement of Operations for the three and nine months ended September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In our pro forma information required under SFAS 123 for the periods prior to 2006, we accounted for forfeitures as they occurred.

At September 30, 2006, there was approximately \$21.5 million of total unrecognized stock-based compensation expense, adjusted for estimated forfeitures, related to unvested share-based awards. Unrecognized stock-based

compensation expense is expected to be recognized over the next 4.2 years on a weighted average basis and will be adjusted for any future changes in estimated forfeitures.



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**5. INCOME TAXES**

For the three months ended September 30, 2006 and 2005, our tax expense was \$5.6 million and \$4.7 million, respectively. For the three months ended September 30, 2006, our tax expense consisted of approximately \$5.1 million of U.S. tax expense and \$0.5 million of foreign tax expense. For the nine months ended September 30, 2006 and 2005, our tax expense was \$20.3 million and \$14.8 million, respectively. For the nine months ended September 30, 2006, our tax expense consisted of approximately \$18.5 million of U.S. tax expense and \$1.8 million of foreign tax expense.

During the three months ended September 30, 2006, we recorded tax expense at a rate that reflected the estimated impact of current year changes in foreign operations. We have established new locations in Shannon, Ireland and Luxembourg. We transferred existing non-U.S. operations to these locations and expanded these operations in order to more effectively manage current international activity and facilitate further international growth. We commenced business operations in these locations on April 1, 2006. These operating changes generally reduce our effective tax rate from prior years.

During the quarter, we recorded, as a discrete item, the tax benefit of research and development tax credits as a result of a study completed during the quarter. The net effect of this benefit reduced our tax expense in the third quarter by approximately \$1.2 million. The research and development credit related to federal and state tax credits generated prior to 2006. Current year federal tax credits are dependent upon federal legislation to extend this benefit.

As of September 30, 2006, we had net U.S. tax loss carryforwards of approximately \$66 million and foreign tax loss carryforwards of \$3 million. The U.S. amount consisted of \$24 million of deductions resulting from exercise of stock options and \$42 million of acquired net operating losses. The U.S. tax loss carryforwards expire in the years 2020 through 2025.

The acquired net operating losses give rise to deferred tax assets for which we believe a full valuation allowance is required since it is not more likely than not that the deferred tax assets will be realized. This valuation allowance is due to anticipated limitations on acquired losses, including limitations under Section 382 of the Internal Revenue Code. Any future release of this valuation allowance will reduce goodwill.

**6. LONG-TERM DEBT**

In 2004 we sold and issued \$195.0 million in aggregate principal amount of 1.25% convertible senior notes due January 1, 2024 (Notes), in a private, unregistered offering. The Notes were sold at 100% of their principal amount. We are required to pay interest on the Notes on January 1 and July 1 of each year so long as the Notes are outstanding. The 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 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 Notes falls below a specified level; the redemption of the 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 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. If a fundamental change, such as a change in our control, as defined in the related indenture, occurs on or before January 1, 2009, we may also be required to purchase the Notes for cash and pay an additional make whole premium payable in our common stock upon the repurchase or conversion of the Notes in connection with the fundamental change. Holders of the Notes have the right to require us to repurchase their Notes prior to maturity on January 1, 2009, 2014 and 2019. We have the right to redeem the Notes, under certain circumstances, on or after July 1, 2007 and prior to January 1, 2009, and we may redeem the Notes at any time on or after January 1, 2009.

In the third quarter of 2006 and 2005, we incurred interest expense of \$0.6 million and \$0.6 million, respectively, on the Notes. We made interest payments of \$1.2 million and \$1.2 million in the third quarter of 2006 and 2005,

respectively. Interest expense on the Notes was \$1.8million for each of the nine months ended September 30, 2006 and September 30, 2005.

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### **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.*

#### **Overview**

We provide outsourced e-commerce solutions globally to a wide variety of companies primarily in the software and high-tech products markets. We were incorporated in 1994 and began building and operating online stores for our clients in 1996. We offer our clients a broad range of services that enable them to effectively build, manage, and grow online sales on a global basis. We focus on helping our clients mitigate risk and grow their revenues. Our services include online store design, development and hosting, store merchandising and optimization, order management, fraud prevention screening, export controls and management, tax management, digital product delivery via download, physical product fulfillment, multi-lingual customer service, e-mail marketing, website optimization, web analytics, and reporting.

Our products and services allow our clients to focus on promoting and marketing their brands while leveraging the investments we have made in technology and infrastructure that facilitate the purchase of products from their online stores. When shoppers visit the store on one of our clients' websites, they are seamlessly transferred to our e-commerce platform. Once on our platform, shoppers can browse for products and make purchases online. After a purchase is made, we either deliver the product digitally via download over the Internet or transmit the order to a third party for physical fulfillment. We also process the buyer's payment, including collection and remittance of applicable taxes, and provide customer service in multiple languages to handle order-related questions.

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' online stores and to improve the sales effectiveness of those stores. Our services include paid search advertising, search engine optimization, affiliate marketing, store optimization, 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.

Our clients include many of the largest software and high-tech products companies and major retailers of these products, including Allume Systems, Inc., Autodesk, Inc., CompUSA, Inc., Hewlett Packard Company, Lexmark, Inc., McAfee, Inc., Microsoft Corporation, OfficeMax Incorporated., Nuance Communications Inc, Symantec Corporation, Trend Micro, Inc. and Webroot Software, Inc.

Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving markets such as e-commerce. See Item 1A of Part II for a discussion of the risk factors that could have a material adverse effect on our business, financial condition and results of operations.

#### **Critical Accounting Policies**

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, ( SFAS 123(R) ) which requires the measurement and recognition of compensation expense for all share-based payments made to employees and directors including stock options, restricted stock grants and employee stock purchases made through our Employee Stock Purchase Plan based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees for periods beginning in 2006.

Prior to the adoption of SFAS 123(R), we had elected to apply the disclosure-only provision of SFAS No. 123,

Accounting for Stock-Based Compensation as amended by SFAS No. 148. Accordingly, we accounted for stock-based compensation using the intrinsic value method prescribed in APB 25 and related interpretations.

Compensation expense for stock options was measured as the excess, if any, of the fair value of our common stock at

the date of grant over the stock option exercise price and we generally recognized no compensation expense for employee stock options.

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We have adopted SFAS 123(R) using the modified prospective transition method, under which prior periods are not revised.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based awards that are ultimately expected to vest during the period. Stock-based compensation expense recognized in our Condensed Consolidated Statement of Operations for the third quarter of 2006 include compensation expense for share-based awards granted prior to, but not yet vested, as of December 31, 2005 as well as compensation expense for the share-based payment awards granted subsequent to December 31, 2005. The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option pricing model. The fair value of restricted stock is determined based on the number of shares granted and the closing price of our common stock on the date of grant. Compensation expense for all share-based payment awards are recognized using the straight-line amortization method over the vesting period. As stock-based compensation expense recognized in our Condensed Consolidated Statement of Operations for the third quarter of 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

As a result of adopting Statement 123(R) on January 1, 2006, our income before income taxes and net income for the three months ended September 30, 2006 were \$3,456 and \$2,170 lower, respectively, than if we had continued to account for share-based compensation under APB 25. Basic and diluted earnings per share for the three months ended September 30, 2006 were \$0.05 and \$0.05 lower, respectively, than if we had continued to account for share-based compensation under APB 25. Our income before income taxes and net income for the nine months ended September 30, 2006, were \$10,388 and \$6,524 lower, respectively, than if we had continued to account for share-based compensation under APB 25. Basic and diluted earnings per share for the nine months ended September 30, 2006 were \$0.17 and \$0.15 lower, respectively, than if we had continued to account for share-based compensation under APB 25.

SFAS 123(R) also requires the benefits of tax deductions in excess of recognized stock-based compensation expense be reported as a financing cash flow, rather than an operating cash flow as required prior to adoption of SFAS 123(R) in our Condensed Consolidated Statement of Cash Flows.

See Note 4 in the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for further information regarding our stock-based compensation plans.

**Results of Operations**

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

|                                                                                              | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|----------------------------------------------------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                                                                              | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                                                                              | <b>2006</b>               | <b>2005</b> | <b>2006</b>              | <b>2005</b> |
| Revenue                                                                                      | 100.0%                    | 100.0%      | 100.0%                   | 100.0%      |
| Cost of Revenue (exclusive of depreciation and amortization expense shown separately below): |                           |             |                          |             |
| Direct cost of services                                                                      | 2.5                       | 2.0         | 2.5                      | 2.2         |
| Network and infrastructure                                                                   | 10.3                      | 9.4         | 9.6                      | 8.9         |
| Sales and marketing                                                                          | 37.8                      | 31.4        | 37.0                     | 30.7        |
| Product research and development                                                             | 11.1                      | 9.8         | 10.4                     | 9.3         |
| General and administrative                                                                   | 10.7                      | 10.0        | 10.9                     | 10.3        |
| Depreciation and amortization                                                                | 3.9                       | 4.3         | 3.4                      | 4.3         |
| Amortization of acquisition-related costs                                                    | 4.4                       | 3.9         | 4.1                      | 4.2         |
| Total costs and expenses                                                                     | 80.7                      | 70.8        | 77.9                     | 69.9        |

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|                                  |       |       |       |       |
|----------------------------------|-------|-------|-------|-------|
| Income from operations           | 19.3  | 29.2  | 22.1  | 30.1  |
| Other income/(expense), net      | 7.7   | 2.9   | 6.7   | 2.3   |
| Income before income tax expense | 27.0  | 32.1  | 28.8  | 32.4  |
| Income tax expense               | 7.4   | 8.9   | 9.0   | 9.3   |
| Net income                       | 19.6% | 23.2% | 19.8% | 23.1% |

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We acquired SWReg in March 2005, Commerce5, Inc. (now DR globalTech, Inc.) in December 2005, Direct Response Technologies, Inc. (now DR Marketing Solutions, Inc.) in January 2006 and MindVision, Inc. in June 2006. Accordingly, our operations during the three months and nine months ended September 30, 2006 included certain revenue and expenses of these acquired operations, with no corresponding revenue and expenses during the same periods of 2005.

**REVENUE.** Our revenue increased to \$75.3 million for the three months ended September 30, 2006 from \$53.2 million for the same period in the prior year, an increase of \$22.2 million, or 41.7%. For the nine months ended September 30, 2006, revenue totaled \$224.6 million, an increase of \$65.8 million, or 41.4%, from revenue of \$158.9 million in the same period of the prior year. The increase was primarily attributable to higher online sales activity across our client base, increased sales from international sites, expanded strategic marketing activities with a larger number of clients, and acquisitions made during 2005 and 2006.

International sales were approximately 39% and 39% of total sales in the three month period ended September 30, 2006 and 2005, respectively, and approximately 40% and 38% of total sales for the nine month period ended September 30, 2006 and 2005, respectively. The year-to-date growth is attributable to a larger number of international stores being operated for our clients as well as the European outsourced e-commerce providers we acquired in 2004 and 2005.

**DIRECT COST OF SERVICES.** Our direct cost of services line item primarily includes the personnel costs and costs related to product fulfillment, physical on demand, our proprietary back-up CD production and client-specific dedicated costs. Direct cost of service expense was \$1.9 million for the three months ended September 30, 2006, up from \$1.1 million for the same period in the prior year. For the nine months ended September 30, 2006, direct cost of service expense was \$5.7 million, up from \$3.5 million for the same period of the prior year. The increase resulted primarily from (i) personnel added to serve new clients, and to handle increased transaction volumes, (ii) recent acquisitions and (iii) stock-based compensation expense related to employee stock options and employee stock purchases recognized under SFAS 123(R). We currently believe that direct cost of services will increase in absolute dollars in 2006 compared to 2005 as we continue to expand our worldwide fulfillment capacity in order to meet anticipated shipment volumes from sales, and expense related to stock-based compensation. See Note 4 Stock-Based Compensation, in the consolidated financial statements for a discussion of the impact of SFAS 123(R), Share Based Payment, which we adopted on January 1, 2006.

**NETWORK AND INFRASTRUCTURE.** Our network and infrastructure expense line item primarily includes the personnel costs and related expenses to operate and maintain our technology platforms, customer service, data communication and data center operations. Network and infrastructure expense was \$7.8 million for the three months ended September 30, 2006, up from \$5.0 million for the same period in the prior year. For the nine months ended September 30, 2006, network and infrastructure expense was \$21.5 million, up from \$14.2 million for the same period in the prior year. The increases resulted primarily from personnel added to support our revenue growth as well as those gained through acquisition of other businesses, costs related to operating new international data centers and from stock-based compensation expense related to employee stock options and employee stock purchases recognized under SFAS 123(R). We currently believe that network and infrastructure expenses will increase in absolute dollars in 2006 compared to 2005 as we continue to expand our worldwide customer service capacity, as we expand the number of operating global data centers, expected increased network usage, which will drive higher Internet connection charges, and as we record expense related to stock-based compensation. See Note 4 Stock-Based Compensation, in the consolidated financial statements for a discussion of the impact of the adoption of SFAS 123(R), Share Based Payment, which we adopted on January 1, 2006.

**SALES AND MARKETING.** Our sales and marketing expense line item primarily includes personnel costs and related expenses, advertising, promotional and product marketing expenses, credit card transaction and other payment processing fees, credit card chargebacks and bad debt expense. Sales and marketing expense increased to \$28.5 million for the three months ended September 30, 2006 from \$16.7 million for the same period in the prior year, an increase of \$11.7 million, or 70.2%. Sales and marketing expense increased to \$83.0 million for the nine months ended September 30, 2006 from \$48.8 million for the same period in the prior year, an increase of \$34.2 million, or 70.0%. The increases primarily resulted from credit card fees directly associated with the increase in revenue and

additional sales, the addition of new international payment methods, personnel and related expenses to support our global growth initiatives, costs from recent acquisitions, and stock-based compensation expense related to employee stock options and employee stock purchases recognized under SFAS 123(R). As a percentage of revenue, sales and marketing expense was 37.8% and 37.0% in the three months and nine months ended September 30, 2006, compared to 31.4% and 30.7% for the same periods in the prior year. During the first nine months of 2006, we continued to expand our presence in global markets, the consumer electronics market, our strategic marketing services programs, and our oneNetwork



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affiliate program. We also expanded our relationships with two of our major partners, Symantec and Microsoft. We currently believe that sales and marketing expenses will increase in absolute dollars in 2006 compared to 2005, as we continue to grow and expand our reach to clients, as we continue to offer increased levels of strategic marketing services, as we incur costs for acquisitions completed in 2005 and 2006, and as we record expense related to stock-based compensation. See Note 4 Stock-Based Compensation, in the consolidated financial statements for a discussion of the impact of SFAS 123(R), Share Based Payment, which we adopted on January 1, 2006.

**PRODUCT RESEARCH AND DEVELOPMENT.** Our product research and development expense line item includes the costs of personnel and related expenses associated with developing and enhancing our technology platforms and related systems. Product research and development expense increased to \$8.3 million and \$23.4 million, respectively, for the three and nine months ended September 30, 2006 from \$5.2 million and \$14.8 million for the same periods in the prior year, an increase of \$3.1 million, or 60.0%, and \$8.6 million, or 58.3%, respectively. The increases were primarily driven by increases in personnel-related expenses to support our growth initiatives, costs from recent acquisitions, development related to our expanded relationship with Microsoft and stock-based compensation expense related to employee stock options and employee stock purchases recognized under SFAS 123(R). During the first nine months of 2006, we continued to advance our remote-control technology, as well as the international and e-marketing capabilities. We capitalized approximately \$0.0 million and \$0.4 million of software development costs related to these efforts in the nine months ended September 30, 2006 and 2005, respectively. We did not capitalize any material costs related to software development during the nine months ended September 30, 2006 and do not expect to capitalize any such costs for the balance of 2006. As a percentage of revenue, product research and development expense was 11.1% and 10.4% in the three and nine months ended September 30, 2006, compared to 9.8% and 9.3% for the same periods in the prior year. We currently believe that product research and development expenses will increase in absolute dollars in 2006 compared to 2005, as a result of (i) continued investments in product development required to remain competitive, (ii) costs from acquisitions completed in 2005 and 2006, and (iii) recording expense related to stock-based compensation. See Note 4 Stock-Based Compensation, in the consolidated financial statements for a discussion of the impact of SFAS 123(R), Share Based Payment, which we adopted on January 1, 2006.

**GENERAL AND ADMINISTRATIVE.** Our general and administrative expense line item primarily includes the costs of executive, accounting, and administrative personnel and related expenses, insurance expense, and professional fees for legal, tax and audit services. General and administrative expenses increased to \$8.1 million and \$24.6 million, respectively, for the three and nine months ended September 30, 2006 from \$5.3 million and \$16.2 million for the same periods in the prior year, an increase of \$2.8 million, or 52.1%, and \$8.3 million, or 51.5%, respectively. The increase resulted primarily from the addition of personnel and facilities to support our global expansion, such as our offices in Ireland and Luxembourg, as well as those gained through acquisition of other businesses, and from stock-based compensation expense related to employee stock options and employee stock purchases recognized under SFAS 123(R). As a percentage of revenue, general and administrative expense was 10.7% and 10.9% for the three and nine months ended September 30, 2006, compared to 10.0% and 10.3% for the same periods in the prior year. We currently believe that general and administrative expenses will increase in absolute dollars in 2006 compared to 2005, as we (i) continue to invest in our infrastructure to support our continued organic growth, (ii) incur costs from acquisitions completed in 2005 and 2006 and (iii) record expense related to stock-based compensation. See Note 4 Stock-Based Compensation, in the consolidated financial statements for a discussion of the impact of SFAS 123(R), Share Based Payment, which we adopted on January 1, 2006.

**AMORTIZATION OF ACQUISITION-RELATED INTANGIBLES.** Our amortization of acquisition-related intangibles line item consists of amortization of intangible assets recorded from 13 of our acquisitions during the past four years. Amortization of acquisition-related intangible assets was \$3.3 million and \$9.2 million, respectively, for the three and nine months ended September 30, 2006 compared to \$2.1 million and \$6.6 million for the same periods in the prior year. The increase was due to additional amortizable assets acquired throughout 2005 and the first half of 2006. We have purchased, and expect to continue purchasing, assets or businesses, which may include the purchase of intangible assets.

**OTHER INCOME, NET.** Our other income, net line item is the total of interest income on our cash, cash equivalents and short-term investments, interest expense on our debt and foreign currency transaction gains and losses. Interest

income was \$6.4 million and \$15.6 million, respectively, for the three and nine months ended September 30, 2006 compared to \$2.7 million and \$6.8 million for the same periods in the prior year. Interest expense was \$0.6 million and \$1.9 million, respectively, for the three and nine months ended September 30, 2006 compared to \$0.6 million and \$1.8 million for the same periods in the prior year. Gains from foreign currency remeasurement were \$0.0 million and \$1.4 million, respectively, for the three and nine months ended September 30, 2006 compared to losses of \$0.6 million and \$1.4 million for the same periods in the prior year. Gains and losses from the sale of investments were immaterial for the three and nine months ended September 30, 2006 and 2005.

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**INCOME TAXES.** For the three months ended September 30, 2006 and 2005, our tax expense was \$5.6 million and \$4.7 million, respectively. For the three months ended September 30, 2006, our tax expense consisted of approximately \$5.1 million of U.S. tax expense and \$0.5 million of foreign tax expense. For the nine months ended September 30, 2006 and 2005, our tax expense was \$20.3 million and \$14.8 million, respectively. For the nine months ended September 30, 2006, our tax expense consisted of approximately \$18.5 million of U.S. tax expense and \$1.8 million of foreign tax expense.

During the three months ended September 30, 2006, we recorded tax expense at a rate that reflected the estimated impact of current year changes in foreign operations. We established new locations in Shannon, Ireland and Luxembourg. We transferred existing non-U.S. operations to these locations and expanded these operations in order to more effectively manage current international activity and facilitate further international growth. We commenced business operations in these locations on April 1, 2006. These operating changes generally reduce our effective tax rate from prior years.

During the quarter, we recorded, as a discrete item, the tax benefit of research and development tax credits as a result of a study completed during the quarter. The net effect of this benefit reduced our tax expense in the third quarter by approximately \$1.2 million. The research and development credit related to federal and state tax credits generated prior to 2006. Current year federal tax credits are dependent upon federal legislation to extend this benefit.

As of September 30, 2006, we had net U.S. tax loss carryforwards of approximately \$66 million and foreign tax loss carryforwards of \$3 million. The U.S. amount consisted of approximately \$24 million of deductions resulting from exercise of stock options and \$42 million of acquired net operating losses. The tax loss carryforwards from exercise of stock options expire in the years 2020 through 2024. The acquired net operating losses expire in the years 2020 through 2025 and are subject to other deductibility restrictions discussed below.

In prior years, there was uncertainty of future realization of the deferred tax assets resulting from temporary differences and from tax loss carryforwards from operations and stock option deductions, therefore a valuation allowance equal to the deferred tax assets was recorded. At December 31, 2005, we evaluated our deferred tax assets related to tax loss carryforwards from stock option deductions and other items and concluded that it was more likely than not that the deferred tax assets would be realized, and accordingly the valuation allowance was reversed.

We also have evaluated our deferred tax assets related to acquired operating losses and we believe a full valuation allowance for these assets is required under GAAP. This valuation allowance is due to anticipated limitations, including limitations under Section 382 of the Internal Revenue Code, on acquired losses. Any future release of this valuation allowance will reduce goodwill.

**Off Balance Sheet Arrangements**

None

**Table of Contents****Liquidity and Capital Resources**

As of September 30, 2006, we had \$335.7 million of cash and cash equivalents, \$240.6 million of short-term investments and working capital of approximately \$452.4 million. Significant components of our working capital are cash and cash equivalents, short term investments and short term receivables net of client and merchant payables. Our primary source of internal liquidity is our operating activities. Net cash provided by operating activities for the nine months ended September 30, 2006 was \$84.7 million, and was primarily the result of net income adjusted for non-cash expenses, partially offset by balance sheet changes such as a decrease in accounts payable. Net cash provided by operating activities for the nine months ended September 30, 2005 was \$64.3 million, and was primarily the result of net income adjusted for non-cash expenses. Due to our adoption of SFAS 123(R), as of January 1, 2006, the impact of the excess tax benefits of stock-based compensation, defined as the benefits of a tax deduction for share-based payment expenses that exceeds the recognized compensation expenses, is now reported under financing activities with a corresponding deduction from operating activities in our Condensed Consolidated Statements of Cash Flows.

Net cash used in investing activities for the nine months ended September 30, 2006 was \$70.3 million and was the result of net purchases of investments of \$19.5 million, cash paid for acquisitions net of cash received of \$38.0 million, and purchases of capital equipment of \$12.8 million. In January 2006, we acquired Direct Response Technologies, Inc. (now DR Marketing Solutions, Inc.) for approximately \$15.0 million in cash, and in June 2006, we acquired MindVision for approximately \$21.2 million in cash payments to stockholders plus the assumption of certain liabilities. Net cash used in investing activities for the nine months ended September 30, 2005 was \$63.9 million and was the result of net purchases of investments of \$47.1 million, cash paid for acquisitions net of cash received of \$9.5 million, and purchases of capital equipment of \$7.3 million. In March 2005, we acquired SWReg, an operating business of Atlantic Coast plc, a private limited UK company, for \$8.8 million in cash.

Net cash provided by financing activities during the nine months ended September 30, 2006 was \$187.2 million. In March 2006, we sold 4.0 million shares of our common stock. The offering provided net proceeds of \$172.7 million, and was made pursuant to a shelf registration statement previously filed with the Securities and Exchange Commission. In addition, proceeds of \$11.5 million were provided by the sale of stock through the exercise of stock options and the employee stock purchase plan, and proceeds of \$3.0 million were provided by the excess tax benefit from stock-based compensation. Net cash provided by financing activities during the nine months ended September 30, 2005 was \$20.4 million from the sale of stock through the exercise of stock options and purchases through the employee stock purchase plan totaling \$23.6 million partially offset by \$3.2 million repurchases of common stock.

Our principal commitments consist of interest and principal on our convertible senior notes and long-term obligations outstanding under operating leases. Although we have no material commitments for capital expenditures, we anticipate continued capital expenditures consistent with our anticipated growth in operations, infrastructure, and personnel. We further anticipate that our expenditures on product development will be consistent with our anticipated growth in operations. We also anticipate that we will continue to experience growth in our operating expenses for the foreseeable future and that our operating expenses will be a material use of our cash resources.

The following table summarizes our principal contractual commitments as of September 30, 2006:

|                                | Total<br>Amount<br>Committed | Payment due by period (in thousands) |           |           |                        |
|--------------------------------|------------------------------|--------------------------------------|-----------|-----------|------------------------|
|                                |                              | Oct-Dec<br>2006                      | 2007-2008 | 2009-2010 | 2011 and<br>Thereafter |
| <b>Contractual Obligations</b> |                              |                                      |           |           |                        |
| Operating Lease Obligations    | \$ 7,300                     | \$907                                | \$ 5,174  | \$1,219   | \$ 0                   |
| Convertible Senior Notes       | \$237,656                    | \$ 0                                 | \$ 4,875  | \$4,875   | \$227,906              |
| Total                          | \$244,956                    | \$907                                | \$10,049  | \$6,094   | \$227,906              |

We expect to continue to evaluate and consider a wide array of potential strategic transactions, including business combinations and acquisitions of businesses, products, services and other assets as well as licenses of technology

related to our current business. At any given time, we may be engaged in discussions or negotiations with respect to one or more such transactions. Any such transactions could have a material impact on our financial position, results of operations, or cash flows. There is no assurance that any such discussions or negotiations will result in the consummation of any transaction. The process of integrating any acquisition may create unforeseen challenges for our operational, financial and management information systems, as well as unforeseen expenditures and other risks, including diversion of management's attention from other business concerns, the potential loss of key customers, employees and business partners, difficulties in managing facilities and employees in different geographic areas, and difficulties in entering markets in which we have no or limited direct

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prior experience and where competitors in such markets have stronger market positions. In addition, an acquisition may cause us to assume liabilities or become subject to litigation. Further, there can be no assurance that we will realize a positive return on any acquisition or that future acquisitions will not be dilutive to our current shareholders percentage ownership or to earnings. We have allocated significant valuation in the form of goodwill and intangibles for the companies we acquired in the past, which is subject to impairment testing on a regular basis. If the individual businesses do not perform as expected at the acquisition dates, we may incur impairment charges for goodwill, accelerated amortization of definite-lived intangible assets due to shortened expected lives of those assets, immediate write-offs and restructuring or other related expenses.

With respect to our convertible senior notes, we are required to pay interest on the notes on January 1 and July 1 of each year so long as the notes are outstanding. On July 3, 2006 we paid \$1.2 million in interest for the period January 1 through June 30, 2006. The 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 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 notes falls below a specified level; the redemption of the 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 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. In addition, contingent interest is required to be paid to holders if certain conditions are met. If a fundamental change, such as a change in our control, as defined in the related indenture, occurs on or before January 1, 2009, we may also be required to purchase the notes for cash and pay an additional make whole premium payable in our common stock upon the repurchase or conversion of the notes in connection with the fundamental change. Holders of the notes have the right to require us to repurchase their notes prior to maturity on January 1, 2009, 2014 and 2019. We have the right to redeem the notes, under certain circumstances, on or after July 1, 2007 and prior to January 1, 2009, and we may redeem the notes at anytime on or after January 1, 2009.

We believe that existing sources of liquidity and the results of our operations will provide adequate cash to fund our operations, although we may seek to raise additional capital. In January 2005, we filed a registration statement to increase our available shelf registration amount from approximately \$55 million to \$255 million. Of this amount, approximately \$173 million was utilized to issue common stock in March 2006, leaving approximately \$82 million available for future use. In addition, we filed an acquisition shelf registration statement for up to approximately 1.5 million shares. In February 2006, we filed a shelf registration that would allow us to sell an undetermined amount of equity or debt securities in accordance with the recently approved rules applying to well known seasoned issuers. These filings were made to provide future flexibility for acquisition and financing purposes. The sale of additional equity or convertible debt securities could result in additional dilution to our stockholders. There can be no assurances that financing will be available in amounts or on terms acceptable to us, if at all.

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**Item 3. Qualitative and Quantitative Disclosure About Market Risk**

**Interest Rate Risk**

Our portfolio of cash equivalents and short-term investments is maintained in a variety of securities, including government 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. At September 30, 2006, all securities held had maturities or reset dates of less than three years. 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 enter into financial instruments for trading or speculative purposes or utilize derivative financial instruments.

At September 30, 2006, we had long-term debt of \$195.0 million associated with our 1.25% convertible senior notes which are due in 2024. 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**

Our business has historically been transacted primarily in the U.S. dollar and, as such, has not been subject to material foreign currency exchange rate risk. However, the growth in our international operations has increased 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. Accordingly, our future results could be materially adversely impacted by changes in these or other factors.

*Transaction Exposure*

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 statement of income. 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. We do not currently have a currency hedging program to mitigate the effect of fluctuations of currency prices on our financial results.

*Translation Exposure*

Foreign exchange rate fluctuations may adversely impact our consolidated financial position as well as our consolidated results of operations. Foreign exchange rate fluctuations may adversely impact our financial position as the assets and liabilities of our foreign operations are translated into U.S. dollars in preparing our consolidated balance sheet. These gains or losses are recognized as an adjustment to stockholders' equity through accumulated other comprehensive income/(loss) net of tax benefit or expense.

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**Item 4. Controls and Procedures**

- (a) Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2006. Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) promulgated under the Securities Exchange Act of 1934) were effective in providing reasonable assurance that material information required to be disclosed by us in this Form 10-Q was recorded, processed, summarized and reported in a timely manner.
- (b) During the quarter ended September 30, 2006, there was no change in our internal control over financial reporting that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**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, control 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.



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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

DDR Holdings, LLC has brought a claim against us and several other defendants regarding United States Patents No. 6,629,135 and 6,993,572, 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. We intend to vigorously defend ourselves in this matter. On September 22, 2006, DDR Holdings filed an application for 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. DDR Holdings has also moved to stay its litigation pending a decision on the reexamination application. We intend to vigorously defend ourselves in this matter.

NetRatings, Inc. has brought a claim against us regarding US Patents Nos. 5,675,510, 6,115,680, 6,108,637, 6,138,155 and 6,763,386, which are owned by NetRatings. These patents claim web analytic and reporting systems. The case was filed in the U.S. District Court for the District of Minnesota on October 5, 2006. The complaint seeks injunctive relief, declaratory relief, damages and attorney's fees. We are in the process of reviewing the complaint. We intend to vigorously defend ourselves in this matter.

On October 31, 2006, a derivative complaint was filed in the United States District Court for the District of Minnesota by a party identifying itself as a shareholder of the Company purporting to act on behalf of the Company against the directors of the Company and certain present and former officers of the Company. The Company is also named as a nominal defendant. The complaint alleges violations of Section 10(b) and 14(a) of the Securities Exchange Act of 1934 and Rule 10b-5, breaches of fiduciary duty, aiding and abetting breaches of fiduciary duty and unjust enrichment arising from alleged option backdating. The complaint seeks monetary damages, disgorgement, rescission of stock options and other relief. The Company intends to vigorously defend itself against this lawsuit.

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 litigation pending against us that is likely to have, individually or in the aggregate, a material adverse effect on our consolidated financial position, results of operation 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.

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 also may 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 enter into costly royalty or licensing agreements.

**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. This quarterly 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.*

**A loss of any client that accounts for a large portion of our revenue would cause our revenue to decline.**

Sales of products for one software publisher client, Symantec Corporation, accounted for approximately 30.3% of our revenue during the third quarter of 2006. In addition, revenues derived from proprietary Digital River services sold to Symantec end-users and dealer network sales of Symantec products together accounted for approximately 17.0% of total Digital River revenue. In addition, a limited number of other software and physical goods clients contribute a large portion of our annual revenue. Contracts with our clients are generally one or two years in length. 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. If our contract with Symantec is not renewed or otherwise terminated, or if revenues from Symantec and Symantec-related services decline for any other reason, our revenue and our ability to sustain profitability could be materially adversely impaired. It is important to our ongoing success that we maintain our key client relationships and, at the same time, develop new client relationships.

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### **We have a limited profitable operating history.**

Our limited profitable operating history, which we first achieved in the quarter ended September 30, 2002, makes it difficult to evaluate our ability to sustain profitability in the future. The success of our business model depends upon our success in generating sufficient transaction and service fees from the use of our e-commerce solutions by existing and future clients. Accordingly, we must maintain our existing relationships and develop new relationships with software publishers, online retailers and physical goods clients. To achieve this goal, we intend to continue to expend significant financial and management resources on the development of additional services, sales and marketing, improved technology and expanded operations. If we are unable to maintain existing, and develop new, client relationships, we will not generate a profitable return on our investments and we will be unable to gain meaningful market share to justify those investments. Further, we may be unable to sustain profitability if our revenues decrease or increase at a slower rate than expected, or if operating expenses exceed our expectations and cannot be adjusted to compensate for lower than expected revenues.

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

Through acquisitions and organic growth, we are rapidly and significantly expanding our operations, both domestically and internationally. 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 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.

### **We intend to continue to expand our international operations and these efforts may not be successful in generating additional revenue.**

We sell products and services to end-users outside the United States and we intend to continue expanding our international presence. In the third quarter of 2006, our sales to international consumers represented approximately 39% of our total sales. Expansion into international markets, particularly the European and Asia-Pacific regions, requires significant resources that we may fail to recover by generating additional revenue. Conducting business outside of the United States is subject to risks, including:

- § Changes in regulatory requirements and tariffs;
- § Uncertainty of application of local commercial, tax, privacy and other laws and regulations;
- § Reduced protection of intellectual property rights;
- § Difficulties in physical distribution for international sales;
- § Higher incidences of credit card fraud and difficulties in accounts receivable collection;
- § The burden and cost of complying with a variety of foreign laws;
- § The possibility of unionization of our workforce outside the United States, particularly in Europe; and
- § Political or economic constraints on international trade or instability.

These risks have grown with the acquisitions of element 5 AG (now Digital River GmbH) and SWReg, which have substantial operations outside the U.S., and with our expansion into the Asia-Pacific region.

We may be unable to successfully and cost-effectively market, sell and distribute our services in foreign markets. This 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 foreign countries may be less advanced than the U.S. Internet infrastructure. If we are unable to successfully expand our international operations, or manage this expansion, our operating results and financial condition could be harmed.

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### **Our operating results are subject to fluctuations in demand for products and services offered by us or our clients.**

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 anti-virus software and anti-spyware software. In particular, sales of anti-virus software represented a significant portion of our revenues in recent years and in the third quarter of 2006, and continue to be very important to our business. Demand for anti-virus software is subject to the unpredictable introduction of significant computer viruses. On May 31, 2006, Microsoft Corporation introduced products to protect businesses and consumers from computer viruses and other security risks. To the extent that Microsoft or others successfully introduce products or services not sold through our platform that are competitive with products and services sold by current Digital River clients (including anti-virus products and services), our revenues could be materially adversely affected.

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

Currently, we collect sales, use, value added tax (VAT) or other similar transaction taxes with respect to electronic software download and physical delivery of products in tax jurisdictions where we believe we have taxable presences. The application of transaction taxes to interstate and international sales over the Internet is complex and evolving. We already are required to collect and remit VAT in the European Union, for example. Local, state or international jurisdictions may seek to impose transaction tax collection obligations on companies like ours that engage in e-commerce, and they may seek to impose taxes retroactively on past transactions that we believed were exempt from transaction tax liability. 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.

### **We could be liable for fraudulent, improper or illegal uses of our platforms.**

In recent years revenues from our "remote control" 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 use our e-commerce services without significant participation from Digital River personnel. Despite our efforts to detect and contractually prohibit the sale of inappropriate and illegal goods and services, the remote control nature of these platforms makes it more likely 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 illegal products for sale via such platforms under innocuous names, further frustrating 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 civil and criminal penalties.

### **Loss of our credit card acceptance privileges would seriously hamper our ability to process the sale of merchandise.**

The payment by end-users for the purchase of digital goods that we process is typically made by credit card or similar payment method. As a result, we must rely on banks or payment processors to process transactions, and must pay a fee for this service. From time to time, credit card associations may increase the interchange fees that they charge for each transaction using one of their cards. 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, or Discover could adopt new operating rules or re-interpret existing rules that we or our processors might find difficult to follow. We have had payment processing agreements with certain of our payment processors terminated due to violations of their rules, and although we have been able to successfully migrate to new processors, such migrations require significant attention from our personnel, and often result in higher fees and customer dissatisfaction. Any disputes or problems associated with our payment processors could impair our ability to give customers the option of using credit cards to fund their payments. If we were unable to accept credit cards, our business would be seriously damaged. We also could be subject to fines or increased fees from MasterCard and Visa if we fail to detect that merchants are engaging in activities that are illegal or activities that are considered high risk,

primarily the sale of certain types of digital content. We may be required to expend significant capital and other resources to monitor these activities.

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### **Our failure to attract and retain software and digital products publishers, manufacturers, online retailers and online channel partners as clients would cause our revenue and operating profits to decline.**

We generate revenue by providing outsourced services to a wide variety of companies, primarily in the software and high-tech products markets. If we cannot develop and maintain satisfactory relationships with software and digital products publishers, manufacturers, online retailers and online channel partners on acceptable commercial terms, we will likely experience a decline in revenue and operating profit. We also depend on our software and digital publisher clients creating and supporting software and digital products that end-users will purchase. If we are unable to obtain sufficient quantities of software and digital products for any reason, or if the quality of service provided by these software and digital products publishers falls below a satisfactory level, we could also experience a decline in revenue, operating profit and end-user satisfaction, and our reputation could be harmed. Our contracts with our software and digital products publisher 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 at least 90 days before the end of the contract. As is common in our industry, we have no material long-term or exclusive contracts or arrangements with any software or digital products publishers that guarantee the availability of software or digital products. Software and digital products publishers that currently supply software or digital products to us may not continue to do so and we may be unable to establish new relationships with software or digital product publishers to supplement or replace existing relationships.

### **Implementing our acquisition strategy could result in dilution and operating difficulties leading to a decline in revenue and operating profit.**

We have acquired, and intend to continue engaging in strategic acquisitions of businesses, technologies, services and products. Since December 2005, we have acquired three businesses, Commerce5, Inc. (now DR globalTech, Inc.), Direct Response Technologies, Inc. (now DR Marketing Solutions, Inc.) and MindVision, Inc. The process of integrating an acquired business, technology, service or product into our business and operations may result in unforeseen operating difficulties and expenditures. Integration of an acquired business also may disrupt our ongoing business, distract management and make it difficult to maintain standards, controls and procedures. Moreover, the anticipated benefits of any acquisition 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. 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.

### **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 January 2005, we filed a registration statement to increase our available shelf registration amount from approximately \$55 million to \$255 million. Of this amount, approximately \$173 million was utilized to issue common stock in March 2006, leaving approximately \$82 million available for future use. In addition, we filed an acquisition shelf for up to approximately 1.5 million shares. In February 2006, we filed a shelf registration that would allow us to sell an undetermined amount of equity or debt securities in accordance with the recently approved rules applying to well-known seasoned issuers. 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. In June 2004, we issued 1.25% convertible notes which require us to make interest payments and will require us to pay principal when the notes become due in 2024 or in the event of acceleration under certain circumstances, unless the notes are converted into our common stock prior to that. We may not have sufficient capital to service this or any future debt securities that we may issue, and the conversion of the notes into our common stock may result in further dilution to our stockholders. Our capital requirements depend on several factors, including the rate of 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 had significant operating losses and negative cash flow from operations since inception. 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.

**Our operating results have fluctuated in the past and are likely to continue to do so, which could cause the price of our common stock to be volatile.**

Our quarterly and annual operating results have fluctuated significantly in the past and are likely to continue 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.



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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 will likely decline. Some of the factors that have or may contribute to fluctuations in our quarterly and annual operating results include:

- § The addition of new clients or loss of current clients;
- § The introduction by us of new websites, web stores or services that may require a substantial investment of our resources;
- § The introduction by others of competitive websites, web stores or services or products;
- § Our ability to continue to upgrade and develop our systems and infrastructure to meet emerging market needs and remain competitive in our service offerings;
- § Economic conditions, particularly those affecting e-commerce;
- § Client decisions to delay new product launches or to invest in e-commerce initiatives;
- § The performance of our newly acquired assets or companies;
- § Slower than anticipated growth of the online market as a vehicle for the purchase of software products;
- § The cost of compliance with U.S. and foreign regulations relating to our business; and
- § Our ability to retain and attract personnel commensurate with our business needs.

In addition, revenue generated by our software and digital commerce services is likely to fluctuate on a seasonal basis that is typical for the software publishing market in general. We believe that our first and fourth quarters are generally seasonally stronger than our second and third quarters due to the timing of new product introductions, which generally do not occur in the summer months, the holiday selling period, and the post-holiday retail season.

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. In addition, the operating results of companies in the electronic commerce industry have, in the past, experienced significant quarter-to-quarter fluctuations that may adversely affect our stock price.

### **Security breaches could hinder our ability to securely transmit confidential information.**

A significant barrier to e-commerce and communications is the secure transmission of confidential information over public networks. Any compromise or elimination of our security could be costly to remedy, damage our reputation and expose us to liability, and dissuade existing and new clients from using our services. 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 end-user credit card numbers. A party who circumvents our security measures 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 breaches. 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 confidential information, thereby inhibiting the growth of our business. To the extent that our activities or those of third-party contractors involve the storage and transmission of proprietary information, such as credit card numbers, security breaches could damage our reputation and expose us to a risk of loss, fines or litigation and possible liability. Our security measures may not prevent security breaches, and failure to prevent security breaches could lead to a loss of existing clients and also deter potential clients away from our services.

**Claims of infringement of other parties intellectual property rights could require us to expend significant resources, enter into unfavorable licenses or require us to change our business plans.**

From time-to-time we are named as a defendant in lawsuits claiming that we have, in some way, violated the intellectual property rights of others. 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. Any assertions or prosecutions of claims like these, could require us to expend significant financial and managerial resources. 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 pursue our current business plan. We expect that we will increasingly be

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subject to patent infringement claims as our services expand in scope and complexity, and our results of operation and financial condition could be materially adversely affected.

### **Claims against us related to the software products that we deliver electronically and the tangible goods that we deliver physically could require us to expend significant resources.**

We may 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. 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. Although we carry general liability insurance and require that our customers indemnify us against end-user 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. Any costs or imposition of liability that are not covered by insurance or indemnification measures could be expensive and time-consuming to address, distract management and delay product deliveries, even if we are ultimately successful in the defense of these claims.

### **The growth of the market for our services depends on the development and maintenance of the Internet infrastructure.**

Our business is based on highly reliable Internet delivery of services. The success of our business therefore depends on the development and maintenance of a sound Internet infrastructure. This includes maintenance of a reliable network backbone with the necessary speed, data capacity and security, as well as timely development of complementary products, such as routers, for providing reliable Internet access and services. Our ability to increase the speed and scope of our services is limited by, and depends upon, the speed and reliability of both the Internet and our clients' internal networks. Consequently, as Internet usage increases, the growth of the market for our services depends upon improvements made to the Internet as well as to individual clients' networking infrastructures to alleviate overloading and congestion. In addition, any delays in the adoption of new standards and protocols required to govern increased levels of Internet activity or increased governmental regulation may have a detrimental effect on the Internet infrastructure.

### **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 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 Art Technology Group, Inc. and IBM Corporation;
- § E-Commerce capabilities custom-developed by companies, such as IBM Global Services and Accenture, Inc.;
- § Other providers of outsourced e-commerce solutions, such as GSI Commerce, Inc., Macrovision Corporation, and asknet Inc.;
- § Companies that provide technologies, services or products that support a portion of the e-commerce process, such as payment processing, including CyberSource Corporation and PayPal Corp.;
- § Companies that offer various online marketing services, technologies and products, including ValueClick, Inc. and 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

§ 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.

We believe that the principal competitive factors in our market are the breadth of products and services offered, the number of clients and online channel partnerships, brand recognition, system reliability and scalability, price, customer service, ease of use, speed to market, convenience and quality of delivery. The online channel partners and the other companies described above may compete directly with us by

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adopting a similar business model. Moreover, while some of these companies also are clients or potential clients of ours, they may compete with our e-commerce outsourcing solution to the extent that they develop e-commerce systems or acquire such systems from other software vendors or service providers.

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. In addition, competitors 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. 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.

### **Changes in government regulation could limit our Internet activities or result in additional costs of doing business over the Internet.**

We are subject to the same international, federal, state and local laws as other companies conducting business over the Internet. Today, there are relatively few laws specifically directed towards conducting business over the Internet. The adoption or modification of laws related to the Internet could harm our business, operating results and financial condition by increasing our costs and administrative burdens. Due to the increasing popularity and use of the Internet, many laws and regulations relating to the Internet are being debated at the international, federal and state levels. These laws and regulations could cover issues 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 and taxation;
- § Fraud;
- § Advertising;
- § Intellectual property rights;
- § Information security; and
- § Quality of products and services.

Applicability to the Internet of existing laws governing issues, such as property ownership, copyrights and other intellectual property issues, taxation, libel, obscenity and personal privacy also could harm our operating results and substantially increase the cost to us of doing business. For example, numerous state legislatures have proposed that tax rules for Internet retailing and catalog sales correspond to enacted tax rules for sales from physical stores. Any requirement that we collect sales tax for each online purchase and remit the tax to the appropriate state authority would be a significant administrative burden to us, and would likely depress online sales. This and any other change in laws applicable to the Internet also might require significant management resources to respond appropriately. The vast majority of these laws were adopted prior to the advent of the Internet, and do not contemplate or address the unique issues raised thereby. Those laws that do reference the Internet, such as the Digital Millennium Copyright Act, are only beginning to be interpreted by the courts, and their applicability and reach are therefore uncertain.

**Failure to develop our technology to accommodate increased traffic 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 in the volume of traffic on our technology platforms. Any inability to add software and hardware or to develop and upgrade existing technology, transaction-processing systems or network infrastructure to manage increased traffic on this platform may cause unanticipated systems disruptions, slower response times and degradation in client services, including impaired quality and speed of order fulfillment. Failure to manage increased traffic could harm our reputation and significantly reduce demand for our services, which would impair the growth of our business. We may be unable to improve and increase the capacity of our network infrastructure sufficiently or anticipate and react to expected increases in the use of the platform to handle increased volume. Further, additional network capacity may not be available from third-party suppliers when we need it. Our network and our suppliers' networks may be unable to maintain an acceptable data transmission capability, especially if demands on the platform increase.

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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. 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. The Internet and the e-commerce industry are characterized by rapid technological changes, changes in user and client requirements and preferences, frequent new product and service introductions embodying new technologies and the emergence of new industry standards and practices that could render our technology and systems obsolete. To be successful, we must adapt to rapid technological changes by licensing and internally developing leading technologies to enhance our existing services, developing new products, services and technologies that address the increasingly sophisticated and varied needs of our clients, and responding to technological advances and emerging industry standards and practices on a cost-effective and timely basis. The development of our proprietary technologies involves significant technical and business risks. We may fail to use new technologies effectively or fail to adapt our proprietary technology and systems to client requirements or emerging industry standards.

### **System failures could reduce the attractiveness of our service offerings.**

We provide commerce, marketing and delivery services to our clients and end-users through our proprietary technology transaction processing and client management systems. These systems also maintain an electronic inventory of 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, affecting all or a portion of our systems, which we believe will continue to occur from time-to-time. Any systems damage 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 and other natural disasters;

§ 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, and Internet and telecommunications failure.

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

### **We may become liable to clients who are dissatisfied with our services.**

We design, develop, implement and manage e-commerce solutions that are crucial to the operation of our clients businesses. Defects in the solutions we develop could result in delayed or lost revenue, adverse end-user reaction, and/or negative publicity, which could require expensive corrections. As a result, clients who experience these adverse consequences either directly or indirectly by using our services could bring claims against us for substantial damages. Any claims asserted could exceed the level of any insurance coverage that may be available to us. The successful assertion of one or more large claims that are uninsured, that exceed insurance coverage or that result in changes to insurance policies, including future premium increases that could adversely affect our operating results or financial condition.

### **We depend on key personnel.**

Our future success significantly depends on the continued services and performance of our senior management. Our performance also depends on our ability to retain and motivate our key technical employees who are skilled in maintaining our proprietary technology platforms. The loss of the services of any of our executive officers or 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. Further, we may need to incur additional operating expenses and divert other management time in order to search for a replacement.

Our future success depends on our ability to continue to identify, attract, hire, train, retain and motivate highly skilled personnel. Competition for these personnel is intense, particularly in the Internet industry. We may be unable to

successfully attract, assimilate or retain sufficiently qualified personnel. In making employment decisions, particularly in the Internet and high-technology industries, job candidates often consider



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the value of stock option grants they are to receive in connection with their employment. Fluctuations in our stock price may make it more difficult to retain and motivate employees. Consequently, potential employees may perceive our equity incentives as less attractive and current employees whose equity incentives are no longer attractively priced may choose not to remain with our organization. In that case, our ability to attract employees will be adversely affected. As a result, our ability to use stock options as equity incentives will be adversely affected, which will make it more difficult to compete for and attract qualified personnel. Finally, should our stock price substantially decline, the retention value of stock options may weaken and employees who hold such options may choose not to remain with our organization.

### **Protecting our intellectual property is critical to our success.**

We regard the protection of our trademarks, copyrights, trade secrets and other intellectual property as critical to our success. We rely on a combination of patent, copyright, trademark, service mark and trade secret laws and contractual restrictions to protect our proprietary rights. We have entered into confidentiality and invention assignment agreements with our employees and contractors, and nondisclosure agreements with parties with whom we conduct business, in order to limit access to and disclosure of our proprietary information. These 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 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. Proprietary rights relating to our technologies will be protected from unauthorized use by third parties only to the extent they are covered by valid and enforceable patents or are effectively maintained as trade secrets. We pursue the registration of our trademarks and service marks in the U.S. and internationally. Effective trademark, service mark, copyright and trade secret protection may not be available in every country in which our services are made available online.

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. 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.

### **Our clients' sales cycles are lengthy, 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 and other prospective customers outside of the software industry. 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 and the signing of a contract. 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. 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 may be impaired.

### **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.

### **We are subject to regulations relating to consumer privacy.**

We collect and maintain end-user data for our clients, 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 of

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personal user information or require online services to establish privacy policies. In addition, the U.S. Federal Trade Commission, or FTC, has urged Congress to adopt legislation regarding the collection and use of personal identifying information obtained from individuals when accessing websites. In the past, the emphasis has been on information obtained from minors. Focus has now shifted to include online privacy protection for minors and adults.

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 end-users, 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. These regulations may inhibit or prohibit the collection and sharing of personal information in ways that could harm our clients or us. The globalization of Internet commerce may be harmed by these and similar regulations because the European Union privacy directive prohibits transmission of personal information outside the European Union. The United States and the European Union have negotiated an agreement providing a safe harbor for those companies who agree to comply with the principles set forth by the U.S. Department of Commerce and agreed to by the European Union. Failure to comply with these principles 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.

### **Compliance with future laws imposed on e-commerce may substantially increase our costs of doing business or otherwise adversely affect our ability to offer our services.**

Because our services are accessible worldwide, and we facilitate sales of products to end-users worldwide, international jurisdictions may claim that we are required to comply with their laws. 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 may be more costly or may require us to change our business practices or restrict our service offerings relative to those provided in the United States. Any failure to comply with foreign laws could subject us to penalties ranging from fines to bans on our ability to offer our services.

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. We and/or our subsidiaries are qualified to do business only in certain states. Failure to qualify as a foreign corporation in a required jurisdiction could subject us to taxes and penalties and could result in our inability to enforce contracts in these jurisdictions.

In addition, we are subject to United States laws governing the conduct of business with other countries, such as export control laws, which prohibit or restrict the export of goods, services and technology to designated countries, denied persons or denied entities from the United States. Violation of these laws could result in fines or other actions by regulatory agencies and result in increased costs of doing business and reduced profits. In addition, any significant changes in these laws, particularly an expansion in export control laws, will increase our costs of compliance and may further restrict our overseas client base.

### **We are exposed to foreign currency exchange risk.**

Sales outside the United States accounted for approximately 39% of our total sales in the third quarter of 2006. 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 remeasurement 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. As we have expanded our international operations, our exposure to exchange rate fluctuations has become more pronounced. We do not currently have a currency hedging program to mitigate the effect of fluctuations of currency prices on our financial results. See Item 7A of Part II in our Annual Report on Form 10-K for the year

ended December 31, 2005, for information demonstrating the effect on our consolidated statements of operations from changes in exchange rates versus the U.S. dollar.

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### **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. 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.

### **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 Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets (SFAS No. 142). The statement generally establishes that goodwill and intangible assets with indefinite lives are not amortized, but are to be tested on an annual basis for impairment and, if impaired, are recorded as an impairment charge in income from operations. As of September 30, 2006, we had goodwill with an indefinite life of \$238.3 million from our acquisitions. 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 and jeopardize our ability to demonstrate sustained profitability. On January 1, 2006, we adopted SFAS 123(R) which requires the measurement and recognition of compensation expense for all stock-based compensation based on estimated fair values. Our operating results for the third quarter of 2006 contain, and our operating results for future periods will contain, a charge for stock-based compensation related to stock options, restricted stock grants and employee stock purchases. As a result of our adoption of SFAS 123(R), our earnings for the third quarter of 2006 were lower than they would have been had we not been required to adopt SFAS 123(R). This will continue to be the case for future periods.

### **Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.**

Keeping abreast of, and in compliance with, changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and the NASDAQ Stock Market rules, have required an increased amount of management attention and external resources. We intend to invest all reasonably necessary resources to comply with evolving corporate governance and public disclosure standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue generating activities to compliance activities.

### **Internet-related stock prices are especially volatile and this volatility may depress our stock price or cause it to fluctuate significantly.**

The stock market, and the trading prices of Internet-related companies in particular, have been notably volatile. This volatility is likely to continue in the short-term and is not necessarily related to the operating performance of affected companies. This broad market and industry volatility could significantly reduce the price of our common stock at any time, without regard to our operating performance. Factors that could cause our stock price in particular to fluctuate include, but are not limited to:

- § Actual or anticipated variations in quarterly operating results;
- § Announcements of technological innovations;
- § The ability to sign new clients and the retention of existing clients;
- § New products or services that we offer;
- § Competitive developments, including new products or services, or new relationships by our competitors;
- § Changes that affect our clients or the viability of their product lines;

- § Changes in financial estimates by securities analysts;
- § Conditions or trends in the Internet and online commerce industries;
- § Global unrest and terrorist activities;
- § Changes in the economic performance and/or market valuations of other Internet or online e-commerce companies;
- § Required changes in generally accepted accounting principles and disclosures;
- § Our announcement of significant acquisitions, strategic partnerships, joint ventures or capital commitments or results of operations or other developments related to those acquisitions;
- § Additions or departures of key personnel; and

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§ Sales or other transactions involving our common stock or our convertible notes.

In addition, our stock price 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 our stock price.

**Provisions of our charter documents, other agreements and Delaware law may inhibit potential acquisition bids for us.**

Certain provisions of our amended and restated certificate of incorporation, bylaws, other agreements and Delaware law could make it more difficult for a third party to acquire us, even if a change in control would be beneficial to our stockholders.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

In April 2005, the Board of Directors authorized a new share repurchase program of up to \$50.0 million of our outstanding shares of common stock. This new program superseded and replaced the \$5.0 million share repurchase program adopted in 2001. Under the new program, the shares may be repurchased in the open market or in privately negotiated transactions. Repurchases are at our discretion based on ongoing assessments of the capital needs of the business, the market price of our common stock and general market conditions. No time limit was set for the completion of the repurchase program.

During the nine months ended September 30, 2006, no shares were repurchased under the 2005 repurchase program. Approximately \$36.6 million remains available for repurchases of our common stock.

| <b>Period</b>                          | <b>Total<br/>number<br/>of shares<br/>purchased</b> | <b>Average<br/>price paid<br/>per share</b> | <b>Total<br/>number of<br/>shares<br/>purchased as<br/>part of<br/>publicly<br/>announced<br/>plan</b> | <b>Approximate<br/>dollar value<br/>of shares that may<br/>yet be<br/>purchased under<br/>the plan<br/><br/>(in millions)</b> |
|----------------------------------------|-----------------------------------------------------|---------------------------------------------|--------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------|
| July 1, 2006 - July 31, 2006           |                                                     |                                             |                                                                                                        | \$ 36.6                                                                                                                       |
| August 1, 2006 - August 31, 2006       |                                                     |                                             |                                                                                                        | \$ 36.6                                                                                                                       |
| September 1, 2006 - September 30, 2006 |                                                     |                                             |                                                                                                        | \$ 36.6                                                                                                                       |

Total



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**Item 6. Exhibits**

(a) Exhibits

**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(1) | Form of Senior Debt Indenture.                                                                                                                                                                                                  |
| 4.3(1) | Form of Subordinated Debt Indenture.                                                                                                                                                                                            |
| 4.4    | References are made to Exhibits 3.1 and 3.2.                                                                                                                                                                                    |
| 4.5(4) | Indenture dated as of June 1, 2004 between Digital River, Inc. and Wells Fargo Bank, N.A. as trustee, including therein the form of the Note.                                                                                   |
| 12.1   | Computation of Ratio of Earnings to Fixed Charges.                                                                                                                                                                              |
| 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.                                                                                                                                                        |
| (1)    | Filed as exhibits 3.1 and 3.3 and exhibits 4.5 and 4.6 to our Registration Statement on Form S-3, File No. 333-81626, filed on January 29, 2002, declared effective on February 12, 2002, 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) Filed as exhibit 99.1 to our Current Report on Form 8-K, filed on July 13, 2004 and incorporated herein by reference.

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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: November 9, 2006

DIGITAL RIVER, INC.

By: /s/ THOMAS M. DONNELLY

Thomas M. Donnelly  
*Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*

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