DIGITAL RIVER INC /DE
Form 10-Q
August 09, 2007

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM TO
Commission file number 000-24643
DIGITAL RIVER, INC.
(Exact name of registrant as specified in its charter)

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

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 þ No o
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 þ Accelerated filer o Non-accelerated filer o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ
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 August 1, 2007 was 40,133,180 shares.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

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

	(Unaudited) June 30, 2007	December 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 409,115	$ 390,243
Short-term investments	271,657	235,699
Accounts receivable, net of allowance of $2,934 and $2,339	45,408	52,392
Deferred income taxes	19,591	19,687
Prepaid expenses and other	7,042	6,025
Total current assets	752,813	704,046
Property and equipment, net	24,879	24,079
Goodwill	239,772	243,799
Intangible assets, net of accumulated amortization of $54,844 and $50,092	17,604	21,106
Deferred income taxes	17,403	1,276
Other assets	12,106	11,957
TOTAL ASSETS	$ 1,064,577	$ 1,006,263
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 126,991	$ 141,386
Accrued payroll	9,238	12,097
Deferred revenue	7,425	7,040
Accrued acquisition costs	1,047	5,654
Other accrued liabilities	43,946	39,982
Total current liabilities	188,647	206,159
NON-CURRENT LIABILITIES:		
Convertible senior notes	195,000	195,000
Other liabilities	9,504	1,345
Total non-current liabilities	204,504	196,345
TOTAL LIABILITIES	393,151	402,504

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; 41,489,101 and 40,458,093 shares issued and outstanding	415	404
Additional paid-in capital	574,820	546,758
Retained earnings	80,081	44,989
Accumulated other comprehensive income	16,110	11,608
Total stockholders equity	671,426	603,759
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,064,577	$ 1,006,263

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)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Revenue	$ 78,227	$ 71,277	$ 169,858	$ 149,291
Costs and expenses:				
Direct cost of services	2,426	1,914	4,989	3,777
Network and infrastructure	7,334	6,298	14,829	13,741
Sales and marketing	32,793	27,628	66,982	54,567
Product research and development	8,235	7,488	16,887	15,090
General and administrative	9,543	8,247	19,656	16,497
Depreciation and amortization	3,291	2,475	6,149	4,728
Amortization of acquisition-related intangibles	1,607	3,038	4,353	5,878
Total costs and expenses	65,229	57,088	133,845	114,278
Income from operations	12,998	14,189	36,013	35,013
Other income, net	8,007	6,392	15,000	9,327
Income before income tax expense	21,005	20,581	51,013	44,340
Income tax expense	6,512	7,292	15,814	14,674
Net income	$ 14,493	$ 13,289	$ 35,199	$ 29,666
Net income per share basic	$ 0.35	$ 0.34	$ 0.86	$ 0.79
Net income per share diluted	$ 0.32	$ 0.30	$ 0.78	$ 0.70
Shares used in per-share calculation basic	41,169	39,452	40,823	37,386
Shares used in per-share calculation diluted	46,637	45,458	46,488	43,319

See accompanying notes to condensed consolidated financial statements.

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

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
OPERATING ACTIVITES:		
Net income	$ 35,199	$ 29,666
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of acquisition-related intangibles	4,353	5,878
Change in accounts receivable allowance, net of acquisitions	570	126
Depreciation and amortization	6,149	4,728
Stock-based compensation expense related to stock-based compensation plans	7,125	6,932
Excess tax benefits from stock-based compensation	(10,027)	(2,705)
Deferred and other income taxes	11,383	12,679
Change in operating assets and liabilities (net of acquisitions):		
Accounts receivable	6,515	(622)
Prepaid and other assets	(1,417)	(2,538)
Accounts payable	(15,997)	(14,263)
Deferred revenue	298	553
Income tax payable	2,861	919
Other accrued liabilities	1,068	2,624
Net cash provided by operating activities	48,080	43,977
INVESTING ACTIVITIES:		
Purchases of investments	(173,092)	(103,413)
Sales of investments	137,395	86,913
Cash paid for acquisitions, net of cash received	(8,540)	(37,235)
Purchases of equipment and capitalized software	(6,577)	(9,162)
Net cash used in investing activities	(50,814)	(62,897)
FINANCING ACTIVITIES:		
Proceeds from sales of common stock		172,700
Exercise of stock options	7,703	9,616
Sales of common stock under employee stock purchase plan	1,244	933
Repurchase of restricted stock to satisfy tax witholding obligation	(377)	
Excess tax benefits from stock-based compensation	10,027	2,705
Net cash provided by financing activities	18,597	185,954
EFFECT OF EXCHANGE RATE CHANGES ON CASH	3,009	1,645
NET INCREASE IN CASH AND CASH EQUIVALENTS	18,872	168,679
CASH AND CASH EQUIVALENTS, beginning of period	390,243	131,770

CASH AND CASH EQUIVALENTS, end of period	$ 409,115	$ 300,449
SUPPLEMENTAL DISCLOSURES:		
Cash paid for interest on Convertible Senior Notes	$ 1,219	$ 1,219
Cash paid for income taxes	$ 1,583	$ 1,083
Noncash investing and financing activities:		
Common stock issued in acquisitions and earn-outs	$ 986	$ 684

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, 2006, as filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2007, are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2007. The December 31, 2006, 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, 2006.

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 six months ended June 30, 2007, and 2006, we did not capitalize any 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.

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 in 2006 and 2007 includes 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 is 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 first quarter of 2007 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.

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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.

Recent Accounting Pronouncements

In September 2006, the FASB issued statement No. 157, Fair Value Measurements , (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, with earlier application encouraged. Any amounts recognized upon adoption as a cumulative effect adjustment will be recorded to the opening balance of retained earnings in the year of adoption. We have not yet determined the impact of this Statement on our financial condition and results of operations.

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. On January 1, 2007, we adopted the provisions of SAB 108 and there was no 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. On January 1, 2007, we adopted the provisions of Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of FASB Statement No. 109 (SFAS 109). As a result of the implementation of FIN 48, we recognized no material adjustment in the liability for unrecognized income tax benefits.

See Note 5 in the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for further information regarding income taxes.

1A. RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

On February 6, 2007, we announced the substantial completion of an internal investigation into our historical stock option granting practices. The investigation uncovered irregularities related to the issuance of certain stock option grants made between 1998 and 2005. A Special Committee of the Board oversaw the investigation. The Special Committee authorized the General Counsel and Chief Financial Officer (who joined Digital River in January 2006 and February 2005, respectively) to conduct the investigation, with the assistance of outside counsel and forensic experts. In particular, as a result of the internal investigation, the Special Committee concluded, and the Audit Committee and Board of Directors agree, that we used incorrect measurement dates for financial accounting purposes for certain stock option grants in prior periods. Therefore, we have recorded additional non-cash stock-based compensation expense and related tax effect with regard to certain past stock option grants, and we restated previously filed financial statements in our Form 10-K for the year ended December 31, 2006. These adjustments, after tax, amounted to $9.4 million, spread over the nine year period from 1998 through 2006.

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

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common shares that would have been outstanding if potentially dilutive common shares had been issued during the period.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Earnings per share basic				
Net income basic	$ 14,493	$ 13,289	$ 35,199	$ 29,666
Weighted average shares outstanding basic	41,169	39,452	40,823	37,386
Earnings per share basic	$ 0.35	$ 0.34	$ 0.86	$ 0.79
Earnings per share diluted				
Net income basic	$ 14,493	$ 13,289	35,199	29,666
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit	435	435	870	870
Net income diluted	$ 14,928	$ 13,724	$ 36,069	$ 30,536
Weighted average shares outstanding basic	41,169	39,452	40,823	37,386
Dilutive impact of non-vested stock and options outstanding	1,043	1,581	1,240	1,508
Dilutive impact of convertible senior notes	4,425	4,425	4,425	4,425
Weighted average shares outstanding diluted	46,637	45,458	46,488	43,319
Net income per share diluted	$ 0.32	$ 0.30	$ 0.78	$ 0.70

In accordance with the Emerging Issues Task Force (EITF), Issue No. 04-8, the unissued shares underlying contingent convertible notes are treated as if such shares were issued and outstanding for the purposes of calculating GAAP diluted earnings per share beginning with the issuance of our 1.25% convertible senior notes on June 1, 2004.

3. BUSINESS COMBINATIONS, GOODWILL AND INTANGIBLE ASSETS

Acquisitions completed in 2006

In June 2006, we acquired all of the capital stock of MindVision, Inc., 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 certain liabilities totaling approximately $3.7 million. In November 2006, we recorded $0.2 million as acquisition cost related to a restructuring plan for employee severance to be paid out over a six month period.

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 provided Direct Response shareholders with an earn-out opportunity based on DR Marketing Solutions, Inc. achieving certain revenue and earnings targets during the first three years subsequent to the acquisition. In 2006, we accrued $3.5 million for future earn-out payments. In 2007, pursuant to the January 2006 acquisition agreement, certain adjustments were made to the earn-out obligations under this agreement. Under the restructured earn-out agreement a final earn-out of $3.5 million was accrued and paid during the second quarter of 2007. These earn-outs have been recorded as goodwill in 2006 and 2007 as they were considered incremental to the purchase price.

Acquisitions completed in 2005

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.

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. The agreement also provided an opportunity for

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earn-outs based on achieving specific revenue and development goals over the first 12 months following the closing of the acquisition. Earn-outs totaling $0.5 million have been recorded as goodwill as of June 30, 2007, as they were considered incremental to the purchase price.

Future Earn-outs

As of June 30, 2007, there was an estimated maximum potential for future earn-outs related to acquisitions of approximately $0.6 million included in goodwill and accrued acquisition costs.

Pro Forma Operating Results (Unaudited)

The 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 six months ended June 30, 2007 and 2006 have been prepared as if each of the acquisitions in 2006 had occurred on January 1, 2006 (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Revenue	$78,227	$72,583	$169,858	$152,749
Income from operations	12,998	13,996	36,013	34,631
Net income	14,493	13,110	35,199	29,064
Basic net income per share	$ 0.35	$ 0.33	$ 0.86	$ 0.78
Diluted net income per share	$ 0.32	$ 0.30	$ 0.78	$ 0.69

This pro forma financial information does not purport to represent results that would actually have been obtained if the transactions had been completed on January 1, 2006, 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 Assets. 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.

We complete our annual impairment test using a two-step approach based 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 six months ended June 30, 2007 and 2006.

DIGITAL RIVER, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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Information regarding our other intangible assets is as follows (in thousands):

	As of June 30, 2007		
	Carrying Amount Gross	Accumulated Amortization	Carrying Amount Net
Customer relationships	$ 43,290	$ 31,279	$ 12,011
Non-compete agreements	5,273	5,216	57
Technology/tradename	23,885	18,349	5,536
Total	$ 72,448	$ 54,844	$ 17,604

	As of December 31, 2006		
	Carrying Amount Gross	Accumulated Amortization	Carrying Amount Net
Customer relationships	$ 43,072	$ 28,890	$ 14,182
Non-compete agreements	5,251	5,017	234
Technology/tradename	22,875	16,185	6,690
Total	$ 71,198	$ 50,092	$ 21,106

Amortization expense for the three months ended June 30, 2007 and 2006 was $1.6 million and $3.0 million, respectively and $4.4 million and $5.9 million for the six months ended June 30, 2007 and 2006 respectively. Estimated amortization expense for the remaining life of the intangible assets, based on intangible assets as of June 30, 2007, is as follows (in thousands):

Year	
2007	$ 2,588
2008	4,475
2009	3,565
2010	1,860
2011	1,286
2012	1,236
Thereafter	2,594
Total	$ 17,604

4. STOCK-BASED COMPENSATION PLANS

Option and Restricted Stock Awards

2007 Plan

The Board of Directors of Digital River, Inc. (the Company) previously adopted the Digital River, Inc. 2007 Equity Incentive Plan (the 2007 Plan), subject to stockholder approval of the 2007 Plan. The Company s stockholders approved the 2007 Plan at the Company s annual stockholder meeting held on May 31, 2007. The number of shares issuable under the 2007 Plan equals 2,000,000 shares of our common stock. In addition, shares not issued under the

1998 Plan shall become available for issuance under the 2007 Plan to the extent a stock option or other stock award under the 1998 Plan expires or terminates before shares of common stock are issued under the award. Under our 2007 Equity Incentive Plan we have the flexibility to grant incentive and non-statutory stock options, restricted stock awards, restricted stock unit awards and performance shares to our directors, employees, and consultants.

1998 Plan

Under our 1998 Equity Incentive Plan, as amended and restated (the 1998 Plan), we have the flexibility to grant incentive and non-statutory stock options, restricted stock awards, restricted stock unit awards and performance shares to our directors, employees, and consultants.

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

General Stock Award Information

As of June 30, 2007, there were 930,826 and 2,000,000 shares available for future awards under our 1998 Plan and 2007 Plan, respectively. 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 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 and 2007 Plan is as follows:

	Shares Available for Grant	Options Outstanding	Options Price Per Share	Weighted Average Price Per Share
Balance, December 31, 2005	1,928,584	4,523,385	$ 2.59 - $31.13	$ 16.69
Granted	(395,000)	395,000	29.75 - 57.36	38.64
Restricted stock effect on shares available for grant	(134,250)	N/A	N/A	N/A
Exercised		(1,219,736)	2.59 - 45.24	17.31
Canceled/expired	140,866	(140,866)	2.59 - 30.69	22.57
Balance, December 31, 2006	1,540,200	3,557,783	$ 2.59 - $57.36	$ 18.68
Granted	(489,376)	489,376	55.31 - 56.61	55.40
Restricted stock effect on shares available for grant	(233,534)	N/A	N/A	N/A
Exercised		(878,075)	2.59 - 45.24	8.77
Canceled/expired	113,536	(113,536)	4.56 - 55.39	36.55
Additional Shares Reserved	2,000,000	N/A	N/A	N/A
Balance, June 30, 2007	2,930,826	3,055,548	$ 2.59 - $57.36	$ 26.74

The total pretax intrinsic value of options exercised during the six months ended June 30, 2007, was $39.6 million.

The following table summarizes significant ranges of outstanding and exercisable options under our 1998 Plan and 2007 Plan as of June 30, 2007:

	Options Outstanding				Options Exercisable		
Exercise Price	Number Outstanding	Weighted Average Life Remaining	Weighted Average Price	Aggregate Intrinsic Value	Number Exercisable	Weighted Average Price	Aggregate Intrinsic Value
$2.59 - $3.88	19,787		$ 2.75	$ 841,010	19,787	$ 2.75	$ 841,010

		3.5 years					
4.56 - 7.55	266,767	4.0 years	5.48	10,609,527	266,767	5.48	10,609,527
9.12 - 13.92	645,013	5.3 years	11.74	21,611,758	548,599	11.89	18,299,937
16.72 - 22.98	543,758	6.3 years	22.33	12,462,836	448,629	22.60	10,162,074
23.01 - 30.69	792,412	7.6 years	27.78	13,844,654	308,839	27.76	5,401,124
33.58 - 57.36	787,811	9.3 years	48.82	2,273,160	105,315	41.62	692,638
$2.59 - $57.36	3,055,548	7.0 years	$ 26.74	$ 61,642,945	1,697,936	$ 18.34	$ 46,006,310

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 $45.25 as of June 30, 2007, which would have been received by the option holders had those option holders exercised their options as of that date.

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A summary of the changes in restricted stock under our 1998 Plan and 2007 Plan as of June 30, 2007, is as follows:

	Restricted Stock	Weighted Average Intrinsic Value
Non-Vested Balance, December 31, 2005		$
Granted	89,500	39.96
Vested		
Forfeited		
Non-Vested Balance, December 31, 2006	89,500	$ 39.96
Granted	155,689	55.39
Vested	(22,502)	38.52
Forfeited	(9,328)	55.39
Non-Vested Balance, June 30, 2007	213,359	$ 50.70

Employee Stock Purchase Plan

We also sponsor an employee stock purchase plan (ESPP) under which 1,200,000 shares have been reserved for purchase by employees. The purchase price of the shares under the ESPP 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 ESPP were 32,354 shares for the six months ended June 30, 2007, and 71,183 shares and 82,471 shares in the years ended December 31, 2006 and 2005, respectively. There were 524,499 shares still reserved under the ESPP as of June 30, 2007.

Inducement Equity Incentive Plan

Effective on December 14, 2005, in connection with our acquisition of Commerce5, Inc. (now DR globalTech, Inc.), 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.

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DIGITAL RIVER, INC.
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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 ESPP 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):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Costs and expenses				
Direct cost of services	$ 226	$ 218	$ 420	$ 432
Network and infrastructure	61	84	133	170
Sales and marketing	1,350	1,323	2,618	2,612
Product research and development	465	591	1,018	1,176
General and administrative	1,547	1,303	2,936	2,542
Stock-based compensation included in costs and expenses	3,649	3,519	7,125	6,932
Tax benefit	(993)	(1,309)	(2,040)	(2,579)
Stock-based compensation expense, net of tax	$ 2,656	$ 2,210	$ 5,085	$ 4,353

Valuation Information under SFAS 123(R)

The weighted-average fair value of stock options granted during the six months ended June 30, 2007 and 2006 were $23.06 and $18.35 per share, respectively, using the Black-Scholes option pricing model with the following weighted average assumptions:

	Six Months Ended June 30,	
	2007	**2006**
Risk-free interest rate	4.5%	4.7%
Expected life (years)	3.5	3.1
Volatility factor	0.51	0.60
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 months ended June 30, 2007 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.

At June 30, 2007, there was approximately $27.1 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 3.8 years on a weighted average basis and will be adjusted for any future changes in estimated forfeitures.

5. INCOME TAXES

For the three months ended June 30, 2007 and 2006, our tax expense was $6.5 million and $7.3 million, respectively. For the three months ended June 30, 2007, our tax expense consisted of approximately $4.2 million of U.S. tax expense and $2.3 million of foreign tax expense. For the six months ended June 30, 2007 and 2006, our tax expense was $15.8 million and $14.7 million, respectively. For the six months ended June 30, 2007, our tax expense consisted of approximately $11.3 million of U.S. tax expense and $4.5 million of foreign tax expense.

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DIGITAL RIVER, INC.
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During the three months ended June 30, 2007, we recorded tax expense at a rate that reflected the estimated impact of current year changes in foreign operations. We have established 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 compared to prior years.

In prior years, there was uncertainty of future realization of the deferred tax assets resulting from acquired U.S. tax loss carry-forwards due to anticipated limitations, including limitations under Section 382 of the Internal Revenue Code. Therefore a valuation allowance equal to the deferred tax assets was recorded. We have evaluated these deferred tax assets and have concluded it is more likely than not that we will realize $11.6 million of these deferred tax assets. This is based on conclusions of an IRC Section 382 analysis completed during the quarter as well as our expected future taxable income. The release of the valuation allowance has been reflected as a reduction to goodwill.

On January 1, 2007, we adopted the provisions of Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of FASB Statement No. 109 (SFAS 109). As a result of the implementation of FIN 48, we recognized no material adjustment in the liability for unrecognized income tax benefits. At the adoption date of January 1, 2007, we had $3.3 million of unrecognized tax benefits, all of which would affect our effective tax rate if recognized. At June 30, 2007, we had $3.9 million of unrecognized tax benefits. We do not believe that any of these unrecognized tax benefits will significantly change within twelve months of the reporting date.

We recognize interest and penalties related to uncertain tax positions in income tax expense. As of January 1, 2007, we had approximately $50,000 of accrued interest related to uncertain tax positions.

The tax years 2003-2006 remain open to examination by the major taxing jurisdictions to which we are subject.

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 second quarter of 2007 and 2006, we incurred interest expense of $0.6 million and $0.6 million, respectively, on the Notes and made no interest payments. Interest expense on the Notes was $1.2 million for each of the six months ended June 30, 2007 and June 30, 2006.

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DIGITAL RIVER, INC.
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7. LITIGATION

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.

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 quickly and cost effectively establish an online sales channel capability and to subsequently manage and grow online sales on a global basis. Our offerings help our clients mitigate risk and grow their online revenues. Our services include design, development and hosting of online stores, store merchandising and optimization, order management, fraud prevention screening, export controls and management, tax compliance and management, digital product delivery via download, physical product fulfillment, multi-lingual customer service, online marketing including e-mail marketing, management of paid search programs, 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 instructions to a third party for physical fulfillment. We also process the buyer s payment, including collection and remittance of applicable taxes, and can provide customer service in multiple languages to handle order-related questions. We believe we are an example of an emerging trend known as Software as a Service (SaaS). We have invested substantial resources to develop our e-commerce software platform and we provide access and use of it to our clients as a service as opposed to selling the software to be operated on their own in-house computer hardware.

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., Computer Associates, Canon Inc., Hewlett Packard Company, Lexmark, Inc., Microsoft Corporation, OfficeMax Incorporated., Nuance Communications Inc, Symantec Corporation, and Trend Micro, Inc.

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

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-

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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.

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 and 2007 includes 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 is recognized using the straight-line amortization method over the vesting period. As stock-based compensation expense recognized in our Condensed Consolidated Statement of Operations 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.

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.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2007	**2006**	**2007**	**2006**
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	3.1	2.7	2.9	2.5
Network and infrastructure	9.4	8.8	8.7	9.2
Sales and marketing	41.9	38.7	39.4	36.5
Product research and development	10.5	10.5	10.0	10.1
General and administrative	12.2	11.6	11.6	11.1
Depreciation and amortization	4.2	3.5	3.6	3.2
Amortization of acquisition-related costs	2.1	4.3	2.6	3.9
Total costs and expenses	83.4	80.1	78.8	76.5
Income from operations	16.6	19.9	21.2	23.5
Other income/(expense), net	10.2	8.9	8.8	6.2
Income before income tax expense	26.8	28.8	30.0	29.7
Income tax expense	8.3	10.2	9.3	9.8
Net income	18.5%	18.6%	20.7%	19.9%

We acquired Direct Response Technologies, Inc. (now DR Marketing Solutions, Inc.) in January 2006 and MindVision, Inc. in June 2006. The results of these acquisitions must be factored into any comparison of our 2007 results to the results for 2006. See Note 3 of our Consolidated Financial Statements in this Form 10-Q for pro forma financial information as if these entities had been acquired on January 1, 2006.

REVENUE. Our revenue increased to $78.2 million for the three months ended June 30, 2007, from $71.3 million for the same period in the prior year, an increase of $6.9 million, or 9.7%. For the six months ended June 30, 2007, revenue totaled $169.9 million, an increase of $20.6 million, or 13.8%, from revenue of $149.3 million in the same period of the prior year. The increase was primarily attributable to higher online sales activity across our client base, growth in the number of software publishers and online retailer clients we served, increased sales from international

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sites, expanded strategic marketing activities with a larger number of clients, and acquisitions. Sales of security software products for PCs represent the largest contributor to our revenues.

International sales were approximately 44% and 42% of total sales in the three month period ended June 30, 2007 and 2006, respectively, and approximately 43% and 41% of total sales for the six month period ended June 30, 2007 and 2006, respectively. The increase was primarily due to expansion of our international operations and strategic marketing services, and from making additional payment options available to global online shoppers.

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 $2.4 million for the three months ended June 30, 2007, up from $1.9 million for the same period in the prior year. For the six months ended June 30, 2007, direct cost of service expense was $5.0 million, up from $3.8 million for the same period of the prior year. The increase resulted primarily from personnel added to serve new clients and to handle increased transaction volumes. We currently believe that direct cost of services will increase in absolute dollars in 2007 compared to 2006 as we continue to expand our worldwide fulfillment capacity in order to meet anticipated shipment volumes from sales.

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 $7.3 million and $6.3 million for the three months ended June 30, 2007 and 2006, respectively. For the six months ended June 30, 2007, network and infrastructure expense was $14.8 million, up from $13.7 million for the same period in the prior year. Increased expenses to support our revenue growth were offset by reductions from Symantec Corporation bringing certain customer service activities in-house. We currently believe that network and infrastructure expenses will be approximately the same in 2007 compared to 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 $32.8 million for the three months ended June 30, 2007, from $27.6 million for the same period in the prior year, an increase of $5.2 million, or 18.8%. Sales and marketing expense increased to $67.0 million for the six months ended June 30, 2007 from $54.6 million for the same period in the prior year, an increase of $12.4 million, or 22.7%. As a percentage of revenue, sales and marketing expense was 41.9% and 39.4% in the three months and six months ended June 30, 2007, compared to 38.7% and 36.5% for the same periods in the prior year. The increases primarily resulted from additional personnel and related expenses to support our new clients and expanded relationships with existing clients, our strategic marketing services programs including paid search advertising, and new international payment methods. We currently believe that sales and marketing expenses will increase in absolute dollars in 2007 compared to 2006, as we continue to expand our presence in global markets and offer increased levels of strategic marketing services to new and existing clients.

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 $8.2 million and $16.9 million, respectively, for the three and six months ended June 30, 2007 from $7.5 million and $15.1 million for the same periods in the prior year, an increase of $0.7 million, or 9.3%, and $1.8 million, or 11.9%, respectively. The increases were primarily driven by increases in personnel-related expenses to support our growth initiatives, and costs from recent acquisitions. During the first half of 2007, we continued to advance our remote-control technology, as well as the international and e-marketing capabilities. We did not capitalize any material costs related to software development during the three and six months ended June 30, 2007 and 2006. As a percentage of revenue, product research and development expense was 10.5% and 10.0% in the three and six months ended June 30, 2007, compared to 10.5% and 10.1% for the same periods in the prior year. We currently believe that product research and development expenses will increase in absolute dollars in 2007 compared to 2006, as a result of continued investments in product development required to remain competitive and costs from acquisitions completed in 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 $9.5 million and $19.7 million, respectively, for the three and six months ended June 30, 2007 from $8.2 million and $16.5 million for the same periods in the prior year, an increase of $1.3 million, or 15.9%, and $3.2 million, or 19.4%, respectively. The increase resulted primarily from litigation and other costs associated with the ongoing review of historical stock option practices, and from the addition of personnel and facilities to support our global expansion, such as our offices in Ireland and Luxembourg. As a percentage of revenue, general and administrative expense was 12.2% and 11.6% for the three and six months ended June 30, 2007, compared to 11.6% and 11.1% for the same periods in the prior year. We currently believe that general and administrative expenses will increase in absolute dollars in 2007 compared to 2006, as we continue to invest in our infrastructure to support our continued organic growth, and as we incur expenses related to the review of historical stock option practices.

DEPRECIATION AND AMORTIZATION. Our depreciation and amortization expense line item includes the depreciation of computer equipment and office furniture and the amortization of purchased and internally developed software, leasehold improvements made to our leased facilities, and debt financing costs. Computer equipment, software and furniture are depreciated under the straight-line method using three to seven year lives, and leasehold improvements are amortized over the shorter of the life of the asset or the remaining length of the lease. Depreciation and amortization expense was $3.3 million and $6.1 million for the three and six months ended June 30, 2007, respectively, compared to $2.5 million and $4.7 million for the same periods in the prior year. The increase was primarily due to depreciation and amortization on new data center equipment, software and facilities. We currently believe that depreciation and amortization expense will increase in absolute dollars in 2007 compared to 2006 as we continue to invest in infrastructure to support our global growth.

AMORTIZATION OF ACQUISITION-RELATED INTANGIBLES. Our amortization of acquisition-related intangibles line item consists of amortization of intangible assets recorded from eight of our acquisitions during the past four years. Amortization of acquisition-related intangible assets was $1.6 million and $4.4 million, respectively, for the three and six months ended June 30, 2007, compared to $3.0 million and $5.9 million for the same periods in the prior year. The decrease was due to lower expense from intangible assets that have become fully amortized partially offset by additional amortization from recent acquisitions. 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 $8.3 million and $16.1 million, respectively, for the three and six months ended June 30, 2007, compared to $5.8 million and $9.2 million for the same periods in the prior year. The increase in interest income was primarily due to higher average cash and short-term investment balances resulting from cash provided by operating activities and net proceeds of $172.7 million from sales of common stock at the end of March 2006, and higher short-term interest rates. Interest expense was unchanged at $0.6 million and $1.2 million, respectively, for the three and six months ended June 30, 2007 and 2006. Foreign currency re-measurement was a gain of $0.3 million and $0.1 million for the three and six months ended June 30, 2007, respectively, compared to a gain of $1.2 million and $1.3 million for the same period in the prior year. Gains and losses from the sale of investments were immaterial for the three and six months ended June 30, 2007 and 2006.

INCOME TAXES. For the three months ended June 30, 2007 and 2006, our tax expense was $6.5 million and $7.3 million, respectively. For the three months ended June 30, 2007, our tax expense consisted of approximately $4.2 million of U.S. tax expense and $2.3 million of foreign tax expense. For the six months ended June 30, 2007 and 2006, our tax expense was $15.8 million and $14.7 million, respectively. For the six months ended June 30, 2007, our tax expense consisted of approximately $11.3 million of U.S. tax expense and $4.5 million of foreign tax expense. During the three months ended June 30, 2007, we recorded tax expense at a rate that reflected the estimated impact of current year changes in foreign operations. In 2006, 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 compared to prior years.

In prior years, there was uncertainty of future realization of the deferred tax assets resulting from acquired U.S. tax loss carryforwards due to anticipated limitations, including limitations under Section 382 of the Internal Revenue Code. Therefore a valuation allowance equal to the deferred tax assets was recorded. We have evaluated these deferred tax assets and have concluded it is more likely than not that we will realize $11.6 million of these deferred tax assets. This is based on conclusions of an IRC Section 382 analysis completed during the quarter as well as our expected future taxable income. The release of the valuation allowance has been reflected as a reduction to goodwill.

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On January 1, 2007, we adopted the provisions of Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of FASB Statement No. 109 (SFAS 109). As a result of the implementation of FIN 48, we recognized no material adjustment in the liability for unrecognized income tax benefits. At the adoption date of January 1, 2007, we had $3.3 million of unrecognized tax benefits, all of which would affect our effective tax rate if recognized. At June 30, 2007, we had $3.9 million of unrecognized tax benefits. We do not believe that any of these unrecognized tax benefits will significantly change within twelve months of the reporting date.

We recognize interest and penalties related to uncertain tax positions in income tax expense. As of January 1, 2007, we had approximately $50,000 of accrued interest related to uncertain tax positions.

The tax years 2003-2006 remain open to examination by the major taxing jurisdictions to which we are subject.

Off Balance Sheet Arrangements

None

Liquidity and Capital Resources

As of June 30, 2007, we had $409.1 million of cash and cash equivalents, $271.7 million of short-term investments and working capital of approximately $564.2 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 six months ended June 30, 2007 and 2006 was $48.1 million and $44.0 million, respectively. Net cash provided by operations during the first half of 2007 and 2006 was primarily the result of net income adjusted for non-cash expenses, and balance sheet changes such as a decrease in accounts payable.

Net cash used in investing activities for the six months ended June 30, 2007, was $50.8 million and was the result of net purchases of investments of $35.7 million, cash paid for acquisitions net of cash received of $8.5 million, and purchases of capital equipment of $6.6 million. Net cash used in investing activities for the six months ended June 30, 2006 was $62.9 million and was the result of net purchases of investments of $16.5 million, cash paid for acquisitions net of cash received of $37.2 million, and purchases of capital equipment of $9.2 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 provided by financing activities during the six months ended June 30, 2007, was $18.6 million. Proceeds of $8.9 million were provided by the sale of stock through the exercise of stock options and the employee stock purchase plan, and proceeds of $10.0 million were provided by the excess tax benefit from stock-based compensation. Net cash provided by financing activities during the six months ended June 30, 2006, was $186.0 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 $10.5 million were provided by the sale of stock through the exercise of stock options and purchases through the employee stock purchase plan.

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 June 30, 2007:

		Payment due by period (in thousands)			
Contractual Obligations	**Total Amount Committed**	**Jul-Dec 2007**	**2008-2009**	**2010-2011**	**2012 and Thereafter**
Operating Lease Obligations	$ 14,042	$ 2,202	$ 4,775	$ 1,398	$ 5,667
Convertible Senior Notes	$ 236,438	$ 1,219	$ 4,875	$ 4,875	$ 225,469
Total	$ 250,480	$ 3,421	$ 9,650	$ 6,273	$ 231,136

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 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 1.25% convertible senior notes due January 1, 2024 (the 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 2, 2007, we paid $1.2 million in interest for the period January 1 through June 30, 2007. 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 any time on or after January 1, 2009.

On June 25, 2007, the Board of Directors authorized a new share repurchase program of up to $200.0 million of our outstanding shares of common stock. This new program supersedes and replaces the $50.0 million share repurchase program adopted in 2005. 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.

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 agency obligations and money market funds. Investments are classified as available-for-sale securities and carried at their market value with cumulative unrealized gains or losses recorded as a component of accumulated other comprehensive income within stockholders equity. At June 30, 2007, 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 June 30, 2007, we had long-term debt of $195.0 million associated with our Notes. 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.

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 Condensed Consolidated Statement of Operations. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency-denominated transactions will result in increased net revenues and operating expenses. Conversely, our net revenues and operating expenses will decrease when the U.S. dollar strengthens against foreign currencies.

Transaction Exposure

The Company enters into short term foreign currency forward contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain assets and liabilities recorded in non-functional currencies. Changes in the fair value of these derivatives are recognized in current earnings in other income and expense.

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 net of tax benefit or expense.

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Item 4. Controls and Procedures

(a) We are committed to maintaining disclosure controls and procedures designed to ensure that information required to be disclosed in our periodic reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Our management, 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 June 30, 2007. 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 June 30, 2007, 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 US 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. In September 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. In December 2006, the Court stayed the litigation pending a decision on the reexamination application. In February 2007, the US Patent and Trademark Office ordered reexamination of DDR s patents. 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 have answered this complaint and are in the early stages of discovery. We intend to vigorously defend ourselves in this matter.

In December 2006, we announced that we had received an informal inquiry from the SEC relating to our stock option grant practices. We have cooperated with the SEC regarding this matter and intend to continue to do so.

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 23.9% of our revenue during the second quarter of 2007. In addition, revenues derived from proprietary Digital River services sold to Symantec end-users and sales of Symantec products through our oneNetwork retail and affiliate channel together accounted for approximately 13.1% 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

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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.

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 second quarter of 2007, our sales to international consumers represented approximately 44% 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;

§ Political, social and economic instability;

§ Import and export license requirements and restrictions of the United States and each other country which we operate; and

§ Political or economic constraints on international trade or instability.

Any of the factors described above may have a material adverse effect on our ability to increase or maintain foreign sales. 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.

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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. In addition, a significant portion of our cash and marketable securities are held in non-U.S. domiciled countries.

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 second quarter of 2007, and continue to be very important to our business. Demand for anti-virus software is subject to the unpredictable introduction of significant computer viruses. In 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.

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.

The matters relating to the investigation by the Special Committee of the Board of Directors and the restatement of our consolidated financial statements may result in additional litigation and governmental enforcement actions.

On February 6, 2007, we announced that an internal review had discovered irregularities related to the issuance of certain stock option grants primarily made between 1998 and 2002. As described in Note 1A, Restatement of Consolidated Financial Statements, in Notes to Consolidated Financial Statements in this Form 10-Q, as a result of the internal review, the Special Committee concluded, and the Audit Committee and Board of Directors agree, that we used incorrect measurement dates for financial accounting purposes for certain stock option grants in prior periods. Therefore, we have recorded additional non-cash stock-based compensation expense and related tax effect with regard to certain past stock option grants, and we have restated previously filed financial statements in our Form 10-K for the year ended December 31, 2006. The full year adjustment to 2006 was recorded in the fourth quarter of 2006 due to its insignificance.

Activities related to our internal review of historical stock option practices have required us to incur substantial expenses for legal, accounting, tax and other professional services, have diverted management s attention from our business, and could in the future harm our business, financial condition, results of operations and cash flows.

While we believe we have made appropriate judgments in determining the correct measurement dates for our stock option grants, the SEC may disagree with the manner in which we have accounted for and reported, or not reported, the financial impact. Accordingly, there is a risk we may have to further restate our prior financial statements, amend prior filings with the SEC, or take other actions not currently contemplated.

Our past stock option granting practices and the restatement of prior financial statements have exposed us to greater risks associated with litigation, regulatory proceedings and government enforcement actions. Several derivative complaints had been filed in federal court against our directors and certain of our executive officers pertaining to allegations relating to stock option grants. These cases were subsequently voluntarily dismissed by the plaintiffs. On December 18, 2006, the SEC initiated an informal inquiry into our historical stock option practices. We have provided the results of our internal review together with supporting documentation to the SEC. We intend to continue to fully cooperate with the SEC s inquiry. No assurance can be given regarding the outcomes from litigation, regulatory proceedings or government enforcement actions relating to our past stock option practices. The resolution of these matters will be time consuming, expensive, and may distract management from the conduct of our business. Furthermore, if we are subject to adverse findings in litigation, regulatory proceedings or government enforcement actions, we could be required to pay damages or penalties or have other remedies imposed, which could harm our business, financial condition, results of operations and cash flows.

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

A key element of our business strategy involves expansion through the acquisitions of businesses, assets, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. Between January 1, 1999 and June 30, 2007, we acquired 25 companies. We continually evaluate and explore strategic opportunities as they arise, including business combination transactions, strategic partnerships, and the purchase or sale of assets, including tangible and intangible assets such as intellectual property. We have acquired, and intend to continue engaging in strategic acquisitions of businesses, technologies, services and products. 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.

Acquisitions may require significant capital infusions, typically entail many risks, and could result in difficulties in assimilating and integrating the operations, personnel, technologies, products and information systems of acquired companies or businesses. We have in the past and may in the future experience delays in the timing and successful integration of an acquired company s technologies and product development, unanticipated costs and expenditures, changing relationships with customers, suppliers and strategic partners, or contractual, intellectual property or employment issues. In addition, key personnel of an acquired company may decide not to work for us. The acquisition of another company or its products and technologies may also require us to enter into a geographic or business market in which we have little or no prior experience.

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. These challenges are magnified as the size of the acquisition increases. Furthermore, these challenges would be even greater if we acquired a business or entered into a business combination transaction with a company that was larger and more difficult to integrate than the companies we have historically acquired. Moreover, the anticipated benefits of any acquisition 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. 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 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.

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

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in each Annual Report on Form 10-K. Section 404 also requires our independent registered public accounting firm to attest to, and report on, management s assessment of our internal control over financial reporting.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Over time, controls may become inadequate because changes in conditions or deterioration in the degree of compliance with policies or procedures may occur. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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

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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 for a participant in our market are the breadth of products and services offered, the number of clients and online channel partnerships a participant has, 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 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 was 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.

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 the value of stock option grants they are to receive in connection with their employment.

Equity awards generally comprise a significant portion of our compensation package for a significant number of our employees. We have also modified our compensation policies by instituting awards of restricted stock, while simultaneously reducing awards of stock options. This modification of our compensation policies and the applicability of the SFAS 123R requirement to expense the fair value of equity awards to employees have increased our operating expenses. We cannot be certain that the changes in our compensation policies will improve our ability to attract, retain and motivate employees. Our inability to attract and retain additional key employees and the increase in stock-based compensation expense could each have an adverse effect on our business, financial condition and results of operations. 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 or retain 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 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 44% of our total sales in the second quarter of 2007. 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 may enter into short-term currency forward contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain assets and liabilities recorded in non-functional currencies. The use of such hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movements in foreign exchange rates. See Item 7A of Part II in our Annual Report on Form 10-K for the year ended December 31, 2006, which was filed on March 1, 2007, for information demonstrating the effect on our consolidated statements of operations from changes in exchange rates versus the U.S. dollar.

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.

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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 June 30, 2007, we had goodwill with an indefinite life of \$239.8 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 second quarter of 2007 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 second quarter of 2007 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
- § 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.

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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.

Item 4. Submission of Matters to a Vote of Security Holders

We held our annual meeting of shareholders on May 31, 2007, in Bloomington, Minnesota. The Company solicited proxies and filed definitive proxy statements with the United States Securities and Exchange Commission pursuant to Regulation 14A. Holders of 37,218,298 shares of the Company s common stock were present in person, or by proxy, representing 90.04% of the Company s 41,334,620 shares outstanding on the record date. The matters voted upon and the votes cast at the meeting were as follows:

Item 1: Election of three Class 2 directors to serve on the Board of Directors for a term of three years (expiring in 2010):

	For	Against
Joel A. Ronning	31,426,069	5,792,229
Perry W. Steiner	30,731,550	6,486,748
J. Paul Thorin	30,246,011	6,972,287

Other individuals whose term of office as Director continued after the meeting included William J. Lansing, Frederic M. Seegal and Thomas F. Madison.

Item 2: Approval of 2007 Equity Incentive Plan:

For	Against	Abstain	Broker Non-Vote
26,834,310	5,032,198	92,485	5,259,305

Item 3: Ratification of the appointment of Ernst & Young LLP as the Company s independent auditor for the fiscal year ending December 31, 2007:

For	Against	Abstain	Broker Non-Vote
34,293,783	2,894,196	30,319	0

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

On June 25, 2007, the Board of Directors authorized a new share repurchase program of up to $200.0 million of our outstanding shares of common stock. This new program supersedes and replaces the $50.0 million share repurchase program adopted in 2005. 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 six months ended June 30, 2007, no shares were repurchased under the 2007 repurchase program. Approximately $200 million remains available for repurchases of our common stock.

Period	**Total number of shares purchased**	**Average price paid per share**	**Total number of shares purchased as part of publicly announced plan**	**Approximate dollar value of shares that may yet be purchased under the plan (in millions)**
April 1, 2007 - April 30, 2007				$ 36.6
May 1, 2007 - May 31, 2007				$ 36.6
June 1, 2007 - June 30, 2007				$ 200.0
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: August 9, 2007

DIGITAL RIVER, INC.

By: /s/ THOMAS M. DONNELLY

Thomas M. Donnelly

Chief Financial Officer

(Principal Financial and Accounting Officer)

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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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