

DIGITAL RIVER INC /DE  
Form 10-Q  
May 10, 2005

**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED March 31, 2005**

**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**

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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification Number)

**9625 WEST 76TH STREET, SUITE 150**  
**EDEN PRAIRIE, MINNESOTA 55344**  
(Address of principal executive offices)

**(952) 253-1234**  
(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes  No

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

**COMMON STOCK, \$0.01 PAR VALUE**  
(Class)

**34,205,564 SHARES**  
Outstanding as of April 29, 2005

DIGITAL RIVER, INC.

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****DIGITAL RIVER, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 142,786	\$ 127,734
Short-term investments	172,826	164,402
Accounts receivable, net of allowance of \$843 and \$1,146	22,580	21,520
Prepaid expenses and other	6,215	1,843
<b>Total current assets</b>	<b>344,407</b>	<b>315,499</b>
<b>PROPERTY AND EQUIPMENT, NET</b>	<b>18,999</b>	<b>17,367</b>
<b>GOODWILL</b>	<b>154,330</b>	<b>148,086</b>
<b>INTANGIBLE ASSETS, net of accumulated amortization of \$30,641 and \$28,245</b>	<b>17,144</b>	<b>17,297</b>
<b>OTHER ASSETS</b>	<b>6,218</b>	<b>6,272</b>
	<b>\$ 541,098</b>	<b>\$ 504,521</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 97,549	\$ 88,052
Accrued payroll	3,842	5,332
Deferred revenue	4,702	3,901
Accrued acquisitions expenses	3,643	6,720
Other accrued liabilities	18,502	12,747
<b>Total current liabilities</b>	<b>128,238</b>	<b>116,752</b>
<b>NON-CURRENT LIABILITIES:</b>		
Convertible senior notes	195,000	195,000
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS EQUITY:</b>		
Preferred Stock, \$.01 par value; 5,000,000 shares authorized; no shares issued or outstanding		
Common Stock, \$.01 par value; 60,000,000 shares authorized; 34,199,880 and 33,652,149 shares issued and outstanding	342	337
Additional paid-in capital	256,091	243,926
Accumulated deficit	(37,127)	(51,164)
Accumulated other comprehensive loss	(1,446)	(330)
<b>Total stockholders equity</b>	<b>217,860</b>	<b>192,769</b>
	<b>\$ 541,098</b>	<b>\$ 504,521</b>

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See accompanying notes to condensed consolidated financial statements.

## DIGITAL RIVER, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data; unaudited)

	Three Months Ended March 31,	
	2005	2004
REVENUE	\$ 54,529	\$ 31,855
COSTS AND EXPENSES (exclusive of depreciation and amortization expense shown separately below)		
Direct cost of services	1,301	618
Network and infrastructure	4,479	3,300
Sales and marketing	16,376	11,468
Product research and development	4,458	2,924
General and administrative	5,615	2,837
Depreciation and amortization	2,122	1,611
Amortization of acquisition related intangibles	2,396	1,579
Total costs and expenses	36,747	24,337
INCOME FROM OPERATIONS	17,782	7,518
OTHER INCOME/(EXPENSE), NET	1,155	97
INCOME BEFORE INCOME TAX EXPENSE	\$ 18,937	\$ 7,615
Income tax expense	4,900	
NET INCOME	\$ 14,037	\$ 7,615
NET INCOME PER SHARE:		
BASIC	\$ 0.41	\$ 0.24
DILUTED	\$ 0.35	\$ 0.22
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
BASIC	33,932	31,620
DILUTED	41,454	35,059

See accompanying notes to condensed consolidated financial statements.

## DIGITAL RIVER, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands; unaudited)

	Three Months Ended March 31,	
	2005	2004
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 14,037	\$ 7,615
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of acquisition related costs	2,396	1,579
Change in accounts receivable allowance	6	66
Depreciation and amortization	2,122	1,611
Tax benefit of stock based compensation	2,600	
Change in operating assets and liabilities:		
Accounts receivable	831	81
Prepaid and other assets	(4,408)	(931)
Accounts payable	4,086	7,904
Litigation reserve	(620)	
Deferred revenue	851	8
Accrued payroll and other accrued liabilities	5,360	1,213
Net cash provided by operating activities	27,261	19,146
<b>INVESTING ACTIVITIES:</b>		
Purchases of investments	(36,485)	(15,000)
Sales of investments	27,277	
Cash paid for acquisitions, net of cash received	(7,306)	(294)
Purchases of equipment	(3,680)	(2,124)
Net cash used in investing activities	(20,194)	(17,418)
<b>FINANCING ACTIVITIES:</b>		
Proceeds from sales of common stock		
Exercise of stock options	8,801	1,470
Sales of common stock under employee stock purchase plan	771	427
Net cash provided by financing activities	9,572	1,897
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(1,587)	
NET INCREASE IN CASH AND CASH EQUIVALENTS	15,052	3,625
CASH AND CASH EQUIVALENTS, beginning of period	127,734	101,878
CASH AND CASH EQUIVALENTS, end of period	\$ 142,786	\$ 105,503
<b>SUPPLEMENTAL DISCLOSURES:</b>		
Cash paid for interest	\$ 1,401	\$

See accompanying notes to condensed consolidated financial statements.

**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, 2004 as filed with the Securities and Exchange Commission. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2005. The December 31, 2004 balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted 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, 2004.

*Foreign Currency Translation*

Foreign currency denominated revenue and expense transactions are remeasured to our functional currency using average exchange rates for the fiscal period. Foreign currency denominated assets and liabilities are remeasured to our functional currency using exchange rate in effect at the respective balance sheet dates. Any gains or losses are included in the consolidated statement of operations within other income (expense), net. The financial position and results of operations of our foreign subsidiaries are measured using local currency as the functional currency. Assets and liabilities are translated to their U.S. dollar equivalents at rates in effect at the respective balance sheet dates and statements of operations and cash flows are translated using average exchange rates for the fiscal period. The resulting translation adjustments are recorded as a component of stockholders' equity.

*Research and Development and Software Development*

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Research and development expenses consist primarily of development personnel and external contractor costs related to the development of new products and services, enhancement of existing products and services, quality assurance and testing. We follow AICPA Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, in accounting for internally developed software. Consistent with SOP 98-1, we capitalized approximately \$2.7 million and \$0.4 million of software development costs related to those efforts for the year 2004 and the three months ended March 31, 2005, respectively. These capitalized costs are included in purchases of equipment within investing activities on our Consolidated Statement of Cash Flows.

### **2. NET INCOME PER SHARE**

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

	Three Months Ended	
	2005	2004
March 31,		
Earnings per share - basic		
Net income - basic	\$ 14,037	\$ 7,615
Weighted average shares outstanding - basic	33,932	31,620
Earning per share - basic	\$ 0.41	\$ 0.24
Earnings per share - diluted		
Net income - basic	14,037	7,615
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit	511	
Net income - diluted	\$ 14,548	\$ 7,615
Weighted average shares outstanding - basic	33,932	31,620
Dilutive impact of options outstanding	3,097	3,439
Dilutive impact of convertible senior notes	4,425	
Diluted weighted average shares outstanding	41,454	35,059
Diluted net income per share	\$ 0.35	\$ 0.22

Subsequent to our issuance of 1.25% convertible senior notes on June 1, 2004, the Emerging Issues Task Force (EITF), Issue No. 04-08, proposed that the unissued shares underlying contingent convertible notes be treated as if such shares were issued and outstanding for the purposes of calculating GAAP diluted earnings per share. The notes are contingently convertible into approximately 4.4 million shares of common stock at an initial conversion price of \$44.063 per share, which have been included in our weighted average shares outstanding calculation since the date of issuance.

### 3. GOODWILL AND INTANGIBLE ASSETS

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

We complete our annual impairment test in the fourth quarter of each fiscal year, and reassess any intangible assets, including goodwill, recorded in connection with earlier acquisitions. There was no impairment of goodwill in the three months ended March 31, 2005 and 2004.

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

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	<b>Carrying Amount Gross</b>	<b>As of March 31, 2005</b>		
		<b>Accumulated Amortization</b>		<b>Net</b>
Customer relationships	\$ 27,154	\$ 15,511	\$	11,643
Non-compete agreements	5,134	3,657		1,477
Technology/tradename	15,497	11,473		4,024
Total	\$ 47,785	\$ 30,641	\$	17,144

	<b>Carrying Amount Gross</b>	<b>As of December 31, 2004</b>		
		<b>Accumulated Amortization</b>		<b>Net</b>
Customer relationships				