DIGITAL RIVER INC /DE
Form 10-Q
October 31, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2014

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

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

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

The number of shares of common stock outstanding at October 1, 2014, was 31,888,021 shares.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DIGITAL RIVER, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	(Unaudited) September 30, 2014	December 31, 2013
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 233,405	$ 483,868
Short-term investments	152,424	115,652
Accounts receivable, net of allowance of $3,062 and $3,206	64,667	70,865
Deferred tax assets	1,455	1,479
Prepaid expenses and other	24,916	27,878
Total current assets	476,867	699,742
Property and equipment, net	47,386	53,770
Goodwill	133,638	139,318
Intangible assets, net	21,565	29,217
Long-term investments	52,965	56,023
Deferred income taxes	1,078	1,037
Other assets	879	2,067
TOTAL ASSETS	$ 734,378	$ 981,174
LIABILITIES AND STOCKHOLDERS’ EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 168,010	$ 187,635
Accrued payroll	15,468	20,058
Deferred revenue	4,522	6,904
Other current liabilities	42,169	55,899
Total current liabilities	230,169	270,496
NON-CURRENT LIABILITIES		
Senior convertible notes	135,180	295,795
Other liabilities	12,454	21,452
Total non-current liabilities	147,634	317,247
TOTAL LIABILITIES	377,803	587,743

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; 50,709,661 and 50,074,977 shares issued	507	501
Treasury stock at cost; 18,821,640 and 16,910,883 shares	(456,696)	(424,416)
Additional paid-in capital	775,704	761,560
Retained earnings	42,590	51,254
Accumulated other comprehensive income (loss)	(5,530)	4,532
Total stockholders' equity	356,575	393,431
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 734,378	$ 981,174

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data; unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue	$ 88,835	$ 87,260	$ 274,028	$ 288,444
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	18,304	16,205	53,275	55,272
Network and infrastructure	13,775	14,648	41,712	44,049
Sales and marketing	25,060	25,013	73,585	80,415
Product research and development	18,297	18,108	55,220	52,967
General and administrative	10,669	12,011	35,310	44,040
Goodwill impairment	-	-	-	21,249
Depreciation and amortization	6,601	5,682	19,469	15,748
Amortization of acquisition-related intangibles	2,038	2,149	6,395	6,360
Total costs and expenses	94,744	93,816	284,966	320,100
Income (loss) from operations	(5,909)	(6,556)	(10,938)	(31,656)
Interest income	469	553	1,735	1,929
Interest expense	(890)	(1,941)	(3,387)	(5,884)
Other income (expense), net	2,063	(297)	1,859	16,717
Loss on extinguishment of debt	-	-	(5,605)	-
Income (loss) from continuing operations before income taxes	(4,267)	(8,241)	(16,336)	(18,894)
Income tax expense (benefit)	(8,278)	(645)	(7,355)	(408)
Income (loss) from continuing operations	4,011	(7,596)	(8,981)	(18,486)
Income (loss) from discontinued operations, net of tax	143	(4,891)	317	(6,238)
Net income (loss)	$ 4,154	$ (12,487)	$ (8,664)	$ (24,724)
Income (loss) per share - basic:				
Income (loss) from continuing operations	$ 0.14	$ (0.24)	$ (0.30)	$ (0.57)
Income (loss) from discontinued operations	-	(0.16)	0.01	(0.19)
Net income (loss) per share - basic	$ 0.14	$ (0.40)	$ (0.29)	$ (0.76)
Income (loss) per share - diluted:				
Income (loss) from continuing operations	$ 0.13	$ (0.24)	$ (0.30)	$ (0.57)
Income (loss) from discontinued operations	0.01	(0.16)	0.01	(0.19)
Net income (loss) per share - diluted	$ 0.14	$ (0.40)	$ (0.29)	$ (0.76)

Shares used in per share calculation - basic	29,665	31,487	30,050	32,435
Shares used in per share calculation - diluted	30,126	31,487	30,050	32,435

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands; unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income (loss)	$ 4,154	$ (12,487)	$ (8,664)	$ (24,724)
Other comprehensive income (loss):				
Unrealized foreign exchange gain (loss) on the revaluation of investments in foreign subsidiaries	(9,857)	8,749	(10,876)	524
Unrealized gain (loss) on investments	(107)	292	666	3,389
Tax benefit (expense)	437	1,053	148	-
Other comprehensive income (loss)	(9,527)	10,094	(10,062)	3,913
Comprehensive income (loss)	$ (5,373)	$ (2,393)	$ (18,726)	$ (20,811)

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands; unaudited)

	Nine Months Ended September 30,	
	2014	2013
OPERATING ACTIVITIES		
Net income (loss)	$ (8,664)	$ (24,724)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Loss (gain) on disposal of discontinued operations	(317)	2,110
Amortization of acquisition-related intangibles	6,395	6,360
Provision for doubtful accounts	599	1,400
Depreciation and amortization	19,469	15,831
Impairment of goodwill	-	21,249
Debt issuance cost amortization	730	1,278
Amortization of investment premiums	1,111	2,246
Loss (gain) on disposal of equipment	(358)	121
Gain on sale of investment	(2,209)	(17,526)
Loss on extinguishment of debt	5,605	-
Stock-based compensation expense	13,239	16,295
Deferred and other income taxes	120	1,715
Change in operating assets and liabilities, net of acquisitions:		
Accounts receivable	3,600	(2,856)
Prepaid and other assets	380	5,940
Accounts payable	(12,816)	(65,721)
Deferred revenue	(2,735)	(4,321)
Income tax payable	(9,630)	(2,151)
Other current liabilities	(6,320)	(2,801)
Net cash provided by (used in) operating activities	8,199	(45,555)
INVESTING ACTIVITIES		
Purchases of investments	(185,180)	(53,243)
Sales of investments	151,834	90,891
Cash received (paid) for cost method investments	1,551	39,636
Cash paid for acquisitions, net of cash received	-	(55,843)
Proceeds from sale of equipment	532	20
Purchases of equipment and capitalized software	(13,612)	(15,662)

Net cash provided by (used in) investing activities	(44,875)	5,799
FINANCING ACTIVITIES		
Repurchase of senior convertible notes	(173,298)	(5,354)
Exercise of stock options	-	1,273
Sales of common stock under employee stock purchase plan	1,015	1,183
Repurchase of common stock	(28,260)	(43,950)
Repurchase of restricted stock to satisfy tax withholding obligation	(4,124)	(4,328)
Net cash provided by (used in) financing activities	(204,667)	(51,176)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(9,120)	6,143
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(250,463)	(84,789)
CASH AND CASH EQUIVALENTS, beginning of period	483,868	542,851
CASH AND CASH EQUIVALENTS, end of period	$ 233,405	$ 458,062
SUPPLEMENTAL DISCLOSURES		
Cash paid for interest on senior convertible notes	$ 2,509	$ 3,123
Cash paid for income taxes	$ 3,663	$ 3,373

See accompanying notes to consolidated financial statements.

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1. BASIS OF PRESENTATION

The unaudited consolidated financial statements of Digital River, Inc. and our wholly owned subsidiaries (we, our, Digital River, or the Company) included herein have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information, and, accordingly, do not include all financial information and footnotes normally required for a complete set of financial statements. These consolidated financial statements should be read in conjunction with our audited consolidated financial statements included in our Form 10-K for the year ended December 31, 2013, as filed with the Securities and Exchange Commission.

The unaudited consolidated statements 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. The results of operations for the three and nine months ended September 30, 2014, are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2014, due to seasonality and other factors. The December 31, 2013, information was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP.

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, 2013. There were no material changes in significant accounting policies during the quarter ended September 30, 2014.

Recent Accounting Pronouncements

ASU 2014-09 – Revenue from Contracts with Customers: In May 2014, the Financial Accounting Standards Board (FASB) issued ASU 2014-09, which revises revenue recognition guidance in order to create a single standard that is intended to improve comparability over a range of industries, companies and geographic areas. The ASU is effective for reporting periods beginning after December 15, 2016, and will be applied retrospectively. We are currently reviewing the revised guidance and assessing the potential impact on our consolidated financial statements.

ASU 2013-11 - Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists: In July 2013, the FASB issued ASU 2013-11, which requires an entity to present unrecognized tax benefits as a reduction of the deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, if net settlement is required or expected. To the extent that net settlement is not required or expected, the unrecognized tax benefit must be presented as a liability. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. ASU No. 2013-11 is effective for reporting periods beginning after December 15, 2013, and should be applied prospectively to all unrecognized tax benefits that exist at the effective date. We adopted the new guidance in ASU 2013-11 as of the period ended March 31, 2014, and its adoption did not have a material impact on our Consolidated Financial Statements.

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

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2. NET INCOME (LOSS) PER SHARE

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Income (loss) from continuing operations per share - basic				
Income (loss) from continuing operations - basic	$ 4,011	$ (7,596)	$ (8,981)	$ (18,486)
Weighted average shares outstanding - basic	29,665	31,487	30,050	32,435
Income (loss) from continuing operations per share - basic	$ 0.14	$ (0.24)	$ (0.30)	$ (0.57)
Income (loss) from continuing operations per share - diluted				
Income (loss) from continuing operations - basic	$ 4,011	$ (7,596)	$ (8,981)	$ (18,486)
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit	-	-	-	-
Income (loss) from continuing operations - diluted	$ 4,011	$ (7,596)	$ (8,981)	$ (18,486)
Weighted average shares outstanding - basic	29,665	31,487	30,050	32,435
Dilutive impact of non-vested stock and options outstanding	461	-	-	-
Dilutive impact of 2004 senior convertible notes	-	-	-	-
Weighted average shares outstanding - diluted	30,126	31,487	30,050	32,435
Income (loss) from continuing operations per share - diluted	$ 0.13	$ (0.24)	$ (0.30)	$ (0.57)

Incremental shares of 544,629 for the three months ended September 30, 2013, and 492,244 and 313,695 incremental shares for the nine months ended September 30, 2014 and 2013, respectively, related to dilutive securities were not included in the diluted net income (loss) per share calculation because the Company reported a loss for these periods. Incremental shares related to dilutive securities have an anti-dilutive impact on net income (loss) per share when a net loss is reported and therefore are not included in the calculation.

Options to purchase 377,235 and 589,943 shares for the three months ended September 30, 2014 and 2013, respectively, and 377,235 and 589,943 shares for the nine months ended September 30, 2014 and 2013 were not included in the computation of diluted net income (loss) per share because their effect on diluted net income (loss) per share would have been anti-dilutive.

Our remaining 2004 senior convertible notes were repurchased in the second quarter of 2014. Prior to the repurchase, the unissued shares underlying our 2004 senior convertible notes, 199,828 weighted average shares for the three months ended September 30, 2013, and weighted average shares of 583 and 199,828 for the nine months ended September 30, 2014 and 2013, respectively, were excluded for the purposes of calculating diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive.

The unissued shares underlying our 2010 senior convertible notes, 2,751,414 and 6,019,607 weighted average shares for the three months ended September 30, 2014 and 2013, respectively, and 3,499,945 and 6,070,600 weighted average shares for the nine months ended September 30, 2014 and 2013, respectively, were excluded for the purpose of calculating diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive.

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3. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) includes revenues, expenses, and gains and losses that are excluded from net earnings under GAAP. Items of comprehensive income (loss) are unrealized gains and losses on investments and foreign currency translation adjustments which are added to net income (loss) to compute comprehensive income (loss). Comprehensive income (loss) related to cumulative translation adjustments has no tax expense or benefit as these funds are indefinitely invested.

The following table summarizes the changes in accumulated other comprehensive income (loss), net of tax, by component for the periods ended September 30, 2014 and 2013, (in thousands):

	Foreign currency translation adjustment	Unrealized gain (loss) on investments	Total
Balance as of December 31, 2013	$ 3,720	$ 812	$ 4,532
Other comprehensive income (loss) before reclassifications	(10,876)	810	(10,066)
Reclassified adjustment for net loss included in net income (loss)	-	4	4
Net current period other comprehensive income (loss)	(10,876)	814	(10,062)
Balance as of September 30, 2014	$ (7,156)	$ 1,626	$ (5,530)
Balance as of December 31, 2012	$ 2,565	$ (5,735)	$ (3,170)
Other comprehensive income (loss) before reclassifications	524	3,393	3,917
Reclassified adjustment for net gain included in net income (loss)	-	(4)	(4)
Net current period other comprehensive income (loss)	524	3,389	3,913
Balance as of September 30, 2013	$ 3,089	$ (2,346)	$ 743

The following table shows the gross amounts reclassified from accumulated other comprehensive income (loss) into the Consolidated Statements of Operations and the associated financial statement line item, for the periods ended September 30, 2014 (in thousands):

		September 30, 2014	
Reclassification out of accumulated other comprehensive income	Financial statement line item	Three Months Ended	Nine Months Ended
Realized gains (losses) on investments			
	Other income (expense), net	$ -	$ (7)
	Income tax benefit (expense)	-	3
	Net income (loss)	$ -	$ (4)

4. FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

The following table sets forth by level within the fair value hierarchy, our financial assets that were accounted for at fair value on a recurring basis at September 30, 2014 and December 31, 2013, (in thousands):

	Fair Value Measurements			
	Total	Level 1	Level 2	Level 3
Balance as of September 30, 2014				
Cash and cash equivalents	$ 233,405	$ 233,405	$ -	$ -
Restricted cash	2,025	2,025	-	-
Certificate of deposit	1,500	1,500		
U.S. government sponsored entities	999	-	999	-
Corporate bonds	129,343	129,343	-	-
Asset backed securities	20,560	-	20,560	-
Market basis equity investments	2,455	2,455	-	-
Auction rate securities	39,102	-	-	39,102
Total assets measured at fair value	$ 429,389	$ 368,728	$ 21,559	$ 39,102
Balance as of December 31, 2013				
Cash and cash equivalents	$ 483,868	$ 483,868	$ -	$ -
Restricted cash	3,560	3,560	-	-
Commercial paper	9,992	9,992	-	-
U.S. government sponsored entities	4,000	-	4,000	-
Corporate bonds	101,660	101,660	-	-
Market basis equity investments	3,549	3,549	-	-

Auction rate securities	41,993	-	-	41,993
Total assets measured at fair value	$ 648,622	$ 602,629	$ 4,000	$ 41,993

The assets held at September 30, 2014 and December 31, 2013 had no transfers between levels of the hierarchy during the respective periods then ended.

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

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)
	Auction rate securities
Balance as of December 31, 2012	$ 37,001
Total unrealized gains (losses) included in other comprehensive income	5,092
Settlements	(100)
Balance as of December 31, 2013	$ 41,993
Total unrealized gains (losses) included in other comprehensive income	2,109
Settlements	(5,000)
Balance as of September 30, 2014	$ 39,102

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

Cash and Cash equivalents. Consist of cash on hand in bank deposits, highly liquid investments and money market accounts. The fair value was measured using quoted market prices and is classified as Level 1. The carrying amount approximates fair value.

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

Certificate of deposits. Consist of bank deposits with a carrying amount that approximates fair value and is classified as Level 1. Maturity dates within one year.

Commercial Paper. Consist of primarily high grade commercial paper. The fair value of these investments was measured using quoted market prices and is classified as Level 1. As of December 31, 2013, the contractual maturities of these investments were within one year.

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

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

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

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

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Auction Rate Securities. As of September 30, 2014, we held $40.7 million of Auction Rate Securities (ARS) at par value which we have recorded at $39.1 million fair value. As of December 31, 2013, we held $45.7 million of ARS at par value which was recorded at $42.0 million fair value. As of September 30, 2014 the ARS are 105—142% over-collateralized and the underlying student loans are guaranteed by the U.S. government.

Due to the illiquid market conditions, the fair value of our ARS is recorded at a discount to par value of $1.6 million, or 4.0%, as of September 30, 2014. This reduction from par value is considered temporary and is recorded in "Accumulated other comprehensive income (loss)". The temporary reduction from par value recorded in "Accumulated other comprehensive income (loss)" was $3.7 million, 8.2%, as of December 31, 2013. For the three months ended September 30, 2014 and 2013, we recorded unrealized gains on our ARS of $0.2 million and $0.1 million, respectively. For the nine months ended September 30, 2014 and 2013, we recorded unrealized gains on our ARS of $2.1 million and $3.3 million. Unrealized gains on our ARS are recorded in "Unrealized gain (loss) on investments" in our Consolidated Statements of Comprehensive Income (Loss).

In evaluating our ARS portfolio, we note sustained performance of our securities, strong parity levels, observed market redemption activity, continued receipt of interest and penalty payments, and an increase in fair value at September 30, 2014 compared to December 31, 2013. As we expect to receive all contractual cash flows, we do not believe the unrealized losses to be credit related. We continue to believe that we will be able to liquidate at par over time. We also anticipate we will have sufficient cash flow from operations to execute our business strategy and fund our operational needs. We do not intend to sell, or believe we will be required to sell, these investments prior to recovery of their amortized cost basis. Accordingly, we treated the fair value decline as temporary.

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

	September 30, 2014			December 31, 2013		
Unobservable inputs						
Redemption period (in years)		6			7	
Credit ratings		A- to AAA			BB+ to AAA	
Penalty coupon rate	1.0 %	to	1.5 %	1.0 %	to	1.5 %
Weighted average annualized yield			1.1 %			1.6 %
Risk adjusted discount rate	4.3 %	to	5.1 %	4.7 %	to	7.8 %

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

The portfolio had a weighted average maturity of 30.1 years at September 30, 2014, and 29.8 years as of December 31, 2013.

We classify our ARS as Level 3 long-term investments until we receive a call or partial call on the securities. As of September 30, 2014 and December 31, 2013, our entire ARS portfolio was classified as Level 3 long-term investments. During the quarter ended September 30, 2014, we settled $5.0 million of ARS due to a call at par. During the year ended December 31, 2013, we settled $0.1 million of ARS due to a partial call at par. The amount of Level 3 assets as a percentage of total assets measured at fair value on a recurring basis was 9.1% and 6.5% as of September 30, 2014 and December 31, 2013, respectively.

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

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, they are not measured at fair value on an ongoing basis but are subject to fair value adjustments only in certain circumstances

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like evidence of impairment. For the three and nine months ended September 30, 2014 and 2013, other than the goodwill impairment recorded during the first quarter of 2013, as further discussed in Note 6 — Goodwill, we had no significant fair value adjustments of assets or liabilities on a nonrecurring basis subsequent to their initial recognition. The inputs used in goodwill impairment fair value calculations fall within Level 3 inputs due to the significant unobservable inputs used to determine fair value.

5. INVESTMENTS

As of September 30, 2014 and December 31, 2013, our available-for-sale securities consisted of the following (in thousands):

			Gross Unrealized Losses			Maturities/Reset Dates	
	Cost	Gross Unrealized Gains	Less than 12 Months	Greater than 12 Months	Fair Value	Less than 12 Months	Greater than 12 Months
Balance as of September 30, 2014							
Certificate of deposit	$ 1,500	$ -	$ -	$ -	$ 1,500	$ 1,500	$ -
U.S. government sponsored entities	1,000	-	(1)	-	999	-	999
Corporate bonds	129,395	85	(137)	-	129,343	56,532	72,811
Market basis equity investments	1,563	895	(3)	-	2,455	-	2,455
Asset backed securities	20,563	20	(23)	-	20,560	-	20,560
Auction rate securities	40,725	-	-	(1,623)	39,102	-	39,102
Total available-for-sale securities	$ 194,746	$ 1,000	$ (164)	$ (1,623)	$ 193,959	$ 58,032	$ 135,927

Balance as of December 31, 2013							
Commercial paper	$ 9,992	$ -	$ -	$ -	$ 9,992	$ 9,992	$ -
U.S. government sponsored entities	4,000	-	-	-	4,000	-	4,000
Corporate bonds	101,400	281	(21)	-	101,660	58,280	43,380
Market basis equity investments	1,668	1,881	-	-	3,549	-	3,549
Auction rate securities	45,725	-	-	(3,732)	41,993	-	41,993
Total available-for-sale securities	$ 162,785	$ 2,162	$ (21)	$ (3,732)	$ 161,194	$ 68,272	$ 92,922

We consider the fair value decline of our investments to be temporary, as we do not intend to sell the investments and it is not likely that we will be required to sell the investments before recovery of their amortized cost basis. See Note 4 — Fair Value Measurements, for further discussion regarding the fair value of ARS. Temporary, unrealized, gains and losses on available for sale securities are recorded in “Accumulated other comprehensive income (loss)” within our Consolidated Balance Sheets.

Realized gains or losses on investments are recorded in our Consolidated Statements of Operations within “Other income (expense), net”. Upon the sale of a security classified as available for sale, the amount reclassified out of “Accumulated other comprehensive income (loss)” into earnings is based on the specific identification method.

As of September 30, 2014 and December 31, 2013, the balance of our cost method equity investment was $11.4 million and $10.5 million, respectively, which is included in “Long-term investments” in our Consolidated Balance Sheets. During the first quarter of 2014, we invested an additional $0.6 million and converted a note receivable of $0.3 million into shares in our cost method equity investment. We have not estimated the fair value of

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our cost method equity investment as of September 30, 2014 as we are not aware of any facts or circumstances that would indicate a decline in the fair value of this investment below its carrying value.

During the first quarter of 2013, we sold a cost method equity investment to a third party and recorded a gain of $11.1 million. During the second quarter of 2013, we received additional funds based on our sales agreement and as a result we recorded an additional gain of $6.5 million. In the third quarter of 2014, we received the third of four anticipated payments under the sales agreement and recorded a gain of $2.2 million. All gains related to this cost basis investment have been recorded in “Other income (expense), net” in our Consolidated Statements of Operations. The fourth and final payment under the sales agreement is due in the third quarter of 2017 and we may receive up to $0.9 million of additional sale proceeds at that time. We have concluded that these additional funds represent contingent gains and have not accounted for them in our consolidated financial statements in accordance with U.S. GAAP.

6. GOODWILL

In the fourth quarter 2012, we determined our goodwill was impaired and recorded a preliminary non-cash pretax goodwill impairment charge. During the first quarter of 2013, we completed our goodwill impairment analysis and recorded an additional non-cash pretax goodwill impairment charge of $21.2 million relating to our single reporting unit. The tax benefit associated with the first quarter impairment was offset by our tax valuation allowance. As previously disclosed, a blended income and market approach was used to determine the applicable impairment changes. The application of goodwill impairment tests is a level 3 fair value measurement and requires management judgment for many of the inputs. Goodwill impairment charges are included as a separate operating expense line item, “Goodwill impairment” within Continuing Operations in our Consolidated Statements of Operations.

7. STOCK-BASED COMPENSATION

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Costs and expenses				
Direct cost of services	$ 38	$ 35	$ 122	$ 124

Network and infrastructure	380	341	1,127	1,083
Sales and marketing	1,452	1,718	4,029	5,349
Product research and development	849	782	2,570	2,553
General and administrative	1,866	1,465	5,391	7,186
Stock-based compensation included in costs and expenses	$ 4,585	$ 4,341	$ 13,239	$ 16,295

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8. INCOME TAXES

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Current tax expense (benefit):				
United States	$ (8,422)	$ (397)	$ (8,130)	$ 1,040
International	144	(248)	775	(1,448)
Total current provision for income taxes	$ (8,278)	$ (645)	$ (7,355)	$ (408)
Tax Rate	194.0 %	7.8 %	45.0 %	2.2 %

During the quarter ended September 30, 2014, $9.1 million of previously unrecognized tax benefits, including $1.4 million of related interest, were released due to the expiration of a statute of limitations. We have taken no new tax positions that result in unrecognized tax benefits during the three and nine month periods ended September 30, 2014. As of September 30, 2014, we had $2.7 million of remaining unrecognized tax benefits, excluding related interest. Approximately $2.1 million of these unrecognized tax benefits would affect our effective tax rate if recognized. As of September 30, 2014, we had approximately $0.4 million of accrued interest related to uncertain tax positions. Due to the potential resolution of examinations currently being performed by taxing authorities and the expiration of various statutes of limitation, it is reasonably possible that the balance of our gross unrecognized tax benefits may change within the next twelve months by a range of zero to $1.4 million.

Our quarterly estimate of our annual effective tax rate is subject to variation due to several factors, including our mix of earnings between tax jurisdictions and the corresponding statutory rates, discrete items and the non-recognition of tax benefits generated by net operating losses in jurisdictions with a valuation allowance.

On a quarterly basis, we assess whether a valuation allowance for net operating loss carryforwards and other deferred tax assets is needed. We concluded during the third quarter of 2014 evaluation that we are required to maintain a valuation allowance against our net U.S. tax assets and certain foreign tax assets.

9. COMMITMENTS AND CONTINGENCIES

Litigation

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

On April 4, 2014, we settled two intellectual property lawsuits with DDR Holdings, LLC, each of which was dismissed with prejudice. The full settlement amount was paid in April 2014.

On March 31, 2014, the U.S. District Court for the District of Minnesota certified a class action against the Company of all persons in the United States who purchased Extended Download Service for Norton Products

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between January 24, 2005, and October 26, 2009. The plaintiffs have sued Symantec Corporation and the Company. The claims against the Company are for alleged violation of the Minnesota Consumer Fraud and False Statement in Advertising Acts and unjust enrichment, based on the Company's sale of Extended Download Service to purchasers of Norton products. We intend to continue to vigorously defend this matter, but cannot predict the timing or ultimate outcome, nor estimate a range of loss, if any, for this matter.

Indemnification Provisions

In the ordinary course of business we have included limited indemnification provisions in certain of our agreements with parties with whom we have commercial relations. Under these contracts, we generally indemnify, hold harmless and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with claims by any third party with respect to our domain names, trademarks, logos and other branding elements to the extent that such marks are applicable to our performance under the subject agreement. In certain agreements, including both agreements under which we have developed technology for certain commercial parties and agreements with our clients, we have provided an indemnity for other types of third-party claims.

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

To date, no significant costs have been incurred, either individually or collectively, in connection with our indemnification provisions

Commitments and Guarantees

At certain times, we enter into agreements where a letter of credit is required to ensure payment of future obligations by counterparties, such as our credit card processors and international taxing jurisdictions. Upon withdrawal, we are obligated to fund the executor bank on demand. We have not set aside specific funds to cover this potential obligation as we can generally recover these costs from our clients. If drawn upon, we expect to fund this commitment with cash and cash equivalents. There were $0.5 million and $0.6 million in undrawn letters of credit as of September 30, 2014 and December 31, 2013.

10. DEBT

2010 Senior Convertible Notes

For the nine months ended September 30, 2014, we repurchased $160.6 million of our 2.00% senior convertible notes (2010 Notes) in the open market for $164.5 million, excluding accrued interest. All repurchases occurred in March 2014. For the nine months ended September 30, 2014, the loss on extinguishment of debt, including the premium on repurchase and acceleration of the recognition of deferred financing fees was $5.5 million. For the nine months ended September 30, 2013, we repurchased $5.4 million of the 2010 Notes in the open market for $5.3 million excluding accrued interest. No repurchases were made in the third quarter of 2013. For the nine months ended September 30, 2013, the net gain on extinguishment of debt, which is the net of the gain on sale and the loss on acceleration of the recognition of deferred financing fees, was immaterial. Notes repurchased are deemed to be extinguished for accounting purposes.

As of September 30, 2014, the carrying value of our 2010 Notes was $135.2 million and the fair value was $134.8 million. As of December 31, 2013, the carrying value of our 2010 Notes was $295.8 million and the fair value was $298.3 million. Fair values are based on the quoted fair market values of the debt. Debt is classified as a level 3 fair value measurement. We determine fair value based on the market approach.

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2004 Senior Convertible Notes

On January 1, 2014, holders of $8.7 million of our 1.25% senior convertible notes (2004 Notes) exercised the option to require us to repurchase those notes at par. The acceleration of the recognition of deferred financing fees related to these repurchased Notes resulted in a $0.1 million charge. On June 6, 2014, the remaining balance of our 2004 Notes of $0.1 million was repurchased. The 2004 Notes that were repurchased on January 1, 2014, were classified as current in “Other current liabilities” in our December 31, 2013, Consolidated Balance Sheet due to the subsequent repurchase.

As of December 31, 2013, the carrying value of our 2004 Notes was $8.8 million and the fair value was $8.9 million. Fair values are based on the quoted fair market values of the debt. Debt is classified as a level 3 fair value measurement. We determine fair value based on the market approach.

11. DISCONTINUED OPERATIONS

On September 30, 2013, we sold CustomCD, Inc., which was based in Portland, Oregon in a stock sale to a former employee. On October 1, 2013, we sold Digital River Education Services, Inc., which was based in Plano, Texas in a stock sale to two former employees. The results of operations of these entities, including the income (losses) on their respective sales, have been excluded from the results of continuing operations and are reported as discontinued operations. We do not allocate interest income or interest expense to discontinued operations. The operating results of the discontinued operations included in our Consolidated Statements of Operations, including adjustments to loss on the respective sales, for the three and nine months ended September 30, 2014 and 2013, were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue	$ -	$ 3,064	$ -	$ 8,044
Income (loss) on discontinued operations before taxes and loss on sales	-	(99)	-	(1,619)
Income (loss) on disposal of discontinued businesses before taxes	41	(2,110)	317	(2,110)
Provision (benefit) for income taxes	(102)	2,682	-	2,509
Income (loss) on discontinued operations, net of tax	$ 143	$ (4,891)	$ 317	$ (6,238)

12. SUBSEQUENT EVENTS

On October 23, 2014, the Company entered into a definitive merger agreement to be acquired by an investor group led by Siris Capital Group, LLC (Siris) in a transaction valued at approximately $840 million. Under the terms of the agreement, Siris will acquire all of the outstanding common shares of Digital River for $26.00 per share in cash. The Company may solicit alternative acquisition proposals from third parties during a 45-day “go-shop” period, following the date of execution of the merger agreement. The Company may be required to pay a termination fee of up to $27.3 million if the merger agreement is terminated under certain circumstances. If approved, the merger agreement is expected to be finalized in early 2015.

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

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

Business Overview

Digital River is a leading provider of global Commerce-as-a-Service (CaaS) solutions. We provide commerce, payments and marketing solutions to business-to-business (B2B) and business-to-consumer (B2C) digital product and cloud service companies as well as branded manufacturers across a variety of vertical markets through our multi-tenant technology, platform and service offerings. Our customers range in size from small to mid-sized companies to multi-national enterprises that serve a wide variety of markets, including, software, consumer electronics, computer games, publishing, travel, music, video games, electronic toys, housewares, medical equipment, power tools and direct-selling, among others.

We offer our customers a broad range of solutions to quickly and cost effectively establish, manage and grow commerce sales channels via Internet-connected devices. We have invested substantial resources to develop our solutions, services, infrastructure and platforms, and to mitigate the risks our customers may encounter when conducting global commerce.

Commerce

Our Commerce-as-a-Service suite includes our commerce experience, tools and capabilities; Commerce Business Infrastructure (CBI), which we believe is a competitive differentiator; and marketing services. Our solutions allow our customers to focus on promoting and marketing their products and brands worldwide while leveraging our technology and global infrastructure investments to facilitate the purchase of products or services through e-commerce stores. We generate a significant proportion of our revenue based on the difference between the selling price and our wholesale purchase price, which can be expressed on a revenue-share basis, meaning that we earn as margin a percentage of the selling price of each product sold through our commerce solution. We believe this model aligns our interests with those of our clients. In addition, we also offer our customers transaction-based models and hybrid combinations of revenue share and transaction models.

· Commerce experience, tools and capabilities: With our commerce experience, tools and capabilities we create and manage world-class commerce sites and online experiences that include all of the classic components of a commerce operation, such as responsive and adaptive design, development and hosting of commerce stores, in-application and in-product commerce experiences, shopping carts, store merchandising and optimization, digital product or license key delivery via download, physical product fulfillment, subscription management, e-marketing services, international payment processing services, web store optimization, web analytics and reporting.

When shoppers decide to purchase a customer's product or service online, they are transferred to a commerce store and/or shopping cart operated by us using our multi-tenant commerce platform. Once on our system, shoppers can browse for products and make purchases using connected devices such as PCs, tablet computers, smartphones and other similar devices. After a purchase is made, we deliver the product or license key digitally via download over the Internet, enable access to the product via a time- or —usage-

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based subscription model or transmit instructions to a third party partner for physical fulfillment of the order.

· Commerce business infrastructure (CBI): Our CBI is the underpinning for our Commerce-as-a-Service suite and our payments solution. We believe it is unique and differentiated, enabling us to manage the complexity of global commerce on behalf of our customers. It includes our merchant-of-record and seller-of-record capabilities, our fraud screening and management capabilities, our order management, business intelligence analytics, customer support services and our integration services capabilities as well as our local business entities, which enable us to have on-the-ground experts, strong localization capabilities and local payment methods and banking relationships; and it enables us to manage legal compliance requirements and export controls and management.

We have invested substantial resources to develop our CBI as part of our multi-tenant SaaS commerce and marketing platform and business processes. We provide access and use of our platform to our clients as a service as opposed to selling the software to be operated on our customers' own in-house computer hardware.

Payments

Our Payments solutions offer our customers a global payments footprint, including a full range of domestic and international payment solutions, 180 global payment methods, 170 international currencies and 50 connections to local banks from across the globe. The payments services we provide ourselves or through third parties include transaction processing, global payment methods, fraud management, cloud-based billing, mobile payments services, and other payment optimization services. Our online payments solutions are designed to help our customers maximize credit card and transaction authorization rates, reduce online shopping cart abandonment, ease entry into new geographies and protect transactions from fraud on a global basis. Our payments offerings can function as independent online payment solutions and as fully integrated components of Digital River's enterprise commerce solution.

Marketing

In addition to the services we provide that facilitate the completion of an online transaction, we also offer services designed to help our clients acquire customers more effectively, sell to those customers more often and more efficiently, and increase the lifetime value and retention of each customer. The e-marketing services we provide are supported through several channels. Our performance marketing services include:

· marketForce: Our marketForce™ digital marketing agency includes a global team of marketers that offer managed direct response e-marketing services. Digital River's e-marketing experts offer managed services that span email and affiliate marketing management, search engine marketing, site optimization, multi-variate testing, mass dynamic personalization and contextual advertising.

· oneNetworkDirect: Through our large oneNetworkDirect™ affiliate network, we provide our customers access to a new sales channel, which can help grow their online businesses. Customers can offer any part of their product catalogs to our network of online channel partners, including online retailers and affiliates. This increases the exposure these products receive and can result in higher sales volumes.

· BlueHornet Email Marketing: Our BlueHornetTM enterprise email marketing service provides traditional as well as social and mobile email marketing capabilities. BlueHornet offers email marketing technology, a service model including account management by expert email marketers, and proactive inbox deliverability management.

We view our operations and manage our business as one reportable segment, providing solutions to companies that want to sell their products and services online.

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

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

Current Period Results

For the three months ended September 30, 2014, we recorded net income of $4.2 million, or $0.14 per diluted share, comprised of net income from continuing operations of $4.0 million, or $0.13 per diluted share and a $0.1 million gain from discontinued operations, $0.01 per diluted share. For the comparative period ended September 30, 2013, we recorded a net loss of $12.5 million, or loss of $0.40 per share, comprised of net loss from continuing operations of $7.6 million, or loss of $0.24 per share, and net loss from discontinued operations of $4.9 million, or loss of $0.16 per share. Revenue for the quarter ended September 30, 2014 was $88.8 million, compared to $87.3 million for the same period in the prior year. The 1.8% growth in revenue quarter over quarter was driven by the addition of new payments clients.

Total costs and expenses in continuing operations for the three months ended September 30, 2014 were $94.7 million compared to $93.8 million in the same period in the prior year, an increase of 1.0%.

As of September 30, 2014 and December 31, 2013, we had $385.8 million and $599.5 million in cash, cash equivalents and short-term investments, respectively.

Results of Operations

The results of the operations of CustomCD, Inc. (CustomCD) and Digital River Education Services, Inc. (DRES), which were sold on September 30, 2013 and October 1, 2013, respectively, have been classified within Discontinued Operations in our Consolidated Statements of Operations for all periods presented.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue	100.0 %	100.0 %	100.0 %	100.0 %
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	20.6	18.5	19.4	19.1
Network and infrastructure	15.5	16.8	15.2	15.3
Sales and marketing	28.2	28.7	26.9	27.9
Product research and development	20.6	20.8	20.2	18.4
General and administrative	12.0	13.8	12.9	15.3
Goodwill impairment	-	-	-	7.4
Depreciation and amortization	7.5	6.5	7.1	5.4
Amortization of acquisition-related intangibles	2.3	2.4	2.3	2.2
Total costs and expenses	106.7	107.5	104.0	111.0
Income (loss) from operations	(6.7)	(7.5)	(4.0)	(11.0)
Interest income	0.5	0.6	0.6	0.6
Interest expense	(1.0)	(2.2)	(1.2)	(2.0)
Other income (expense), net	2.3	(0.3)	0.7	5.8
Gain (loss) on extinguishment of debt	-	-	(2.0)	-
Income (loss) from continuing operations before income taxes	(4.9)	(9.4)	(5.9)	(6.6)
Income tax expense (benefit)	(9.3)	(0.7)	(2.7)	(0.2)
Income (loss) from continuing operations	4.4	(8.7)	(3.2)	(6.4)
Income (loss) from discontinued operations, net of tax	0.2	(5.6)	0.1	(2.2)
Net income (loss)	4.6 %	(14.3) %	(3.1) %	(8.6) %

Revenue. Our revenue was $88.8 million and $87.3 million for the three months ended September 30, 2014 and 2013, respectively, an increase of $1.5 million or 1.8%. For the nine months ended September 30, 2014, revenue totaled $274.0 million, a decrease of $14.4 million or 5.0%, from revenue of $288.4 million for the same period in the prior year.

Our revenue is driven primarily by global commerce and payment services provided to a wide variety of companies in the software, consumer electronics, computer games and other markets.

Payments revenue for the three and nine months ended September 30, 2014, increased $1.8 million or 12.7%, and $4.6 million or 10.1%, respectively. The growth in both periods is mainly related to the addition of new clients.

Commerce revenue, including Microsoft, for the three months ended September 30, 2014 was consistent with the same period in the prior year, decreasing $0.3 million or 0.4%. For the nine months ended September 30, 2014, commerce revenue decreased $19.0 million or 7.8%, due primarily to client attrition, as well as one-time significant product launches that occurred in the first quarter of 2013.

International sales were approximately 46.4% and 47.6% of revenue from continuing operations in the three and nine month periods ended September 30, 2014, compared to 46.8% and 47.7% for the same periods in the prior year.

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Direct Cost of Services. Direct cost of services includes payment processing fees, chargeback expense, fraud detection and prevention, costs related to product fulfillment, delivery solutions and certain client-specific costs. Direct cost of services were $18.3 million for the three months ended September 30, 2014, compared to $16.2 million for the same period in the prior year. The increase was primarily related to higher payment processing costs. For the nine months ended September 30, 2014, direct cost of services was $53.3 million compared to $55.3 million for the same period in the prior year. Higher costs in 2013 were primarily due to CD costs related to one time significant product launches in the first quarter of 2013.

Network and Infrastructure. Our network and infrastructure expenses primarily include costs to operate and maintain our technology platforms, customer service, data communication and data center operations. Network and infrastructure expenses were $13.8 million and $14.6 million for the three months ended September 30, 2014 and 2013, respectively. For the nine months ended September 30, 2014 and 2013, network and infrastructure expenses were $41.7 million and $44.0 million, respectively. The decreases for both periods were primarily related to reductions in workforce, consulting, and overhead related expenses.

Sales and Marketing. Our sales and marketing expenses include personnel and related costs, advertising, promotional and product marketing expenses. Sales and marketing expenses were $25.1 million for the three months ended September 30, 2014, consistent with $25.0 million for the same period in the prior year. For the nine months ended September 30, 2014 and 2013, sales and marketing expenses were $73.6 million and $80.4 million, respectively. The decrease year-over year was driven by reductions in workforce costs, including severance and stock compensation expense incurred in 2013 as part of planned cost reduction strategies, and lower marketing expense, including the utilization of third parties.

Product Research and Development. Our product research and development expenses include costs associated with design, development and enhancement of our technology platforms and related systems. Research and development costs are expensed as incurred, except certain internal-use software development costs that are eligible for capitalization and costs directly associated with preparing a client website launch that are eligible to be deferred and amortized over the life of the site's associated revenue streams. Product research and development expenses were $18.3 million and $18.1 million for the three months ended September 30, 2014 and 2013, respectively, and $55.2 million and $53.0 million for the nine months ended September 30, 2014 and 2013, respectively. The increases for both periods were driven by employee and contractor expenses related to the continued investment in our platforms.

General and Administrative. Our general and administrative expenses primarily include executive, finance, human resources and other administrative workforce and other related expenses, fees for professional services, bank fees, litigation costs, insurance costs, acquisition and integration costs and non-income related taxes. General and administrative expenses were $10.7 million and $12.0 million for the three months ended September 30, 2014 and 2013, respectively. The decrease was primarily related to strategic consulting expenses incurred in 2013 associated with business transformation plans, as well as lower legal and professional services spending. For the nine months ended September 30, 2014 and 2013, general and administrative expenses were $35.3 million and $44.0 million, respectively. In addition to the quarter over quarter decreases, the nine months in 2013 included acquisition and integration costs associated with the acquisition of LML Payment Systems, Inc. and severance and stock compensation expense associated with an executive departure.

Goodwill Impairment. During the first quarter of 2013, we completed our fiscal year 2012 goodwill impairment analysis and recorded an additional non-cash pretax goodwill impairment charge of $21.2 million.

Depreciation and Amortization. Our depreciation and amortization expenses include the depreciation of computer equipment, office furniture and leasehold improvements and the amortization of purchased and internally developed software. Computer equipment, software and furniture are depreciated/amortized under the straight-line method using three to seven year lives and leasehold improvements are depreciated over the shorter of the life of the asset or the remaining length of the lease. Depreciation and amortization expense was $6.6 million and $5.7 million for the three months ended September 30, 2014 and 2013, respectively. Depreciation and amortization expense was $19.5 million and $15.7 million for the nine months ended September 30, 2014 and 2013, respectively. The increase in depreciation and amortization in both periods is primarily related to assets acquired for our new data center which were put into service during the third quarter of 2013.

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Amortization of Acquisition-Related Intangibles. Acquisition-related intangibles consists of the assets such as customer relationships, technology and trade names acquired in business combinations. Amortization of acquisition-related intangible assets was $2.0 million for the three months ended September 30, 2014, consistent with the $2.1 million recognized in the three months ended September 30, 2013. Amortization of acquisition-related intangible assets was $6.4 million for both of the nine months ended September 30, 2014 and 2013.

Interest Income. Our interest income represents the total of interest income on our cash, cash equivalents, short-term investments and certain long-term investments. Interest income was $0.5 million and $0.6 million for the three months ended September 30, 2014 and 2013, respectively. Interest income was $1.7 million and $1.9 million for the nine months ended September 30, 2014 and 2013, respectively. The small decrease in interest income in both periods is related to lower total cash and cash equivalent and investment balances due to senior convertible note and stock repurchases over the past year.

Interest Expense. Our interest expense includes the total of cash and non-cash interest expense attributable to our outstanding convertible debt. For the three months ended September 30, 2014 and 2013, interest expense was $0.9 million and $1.9 million, respectively, which included $0.2 million and $0.4 million of debt financing cost amortization, respectively. For the nine months ended September 30, 2014 and 2013, interest expense was $3.4 million and $5.9 million, respectively, which included $0.7 million and $1.3 million of debt financing cost amortization, respectively. The decrease in interest expense in both periods was due to the repurchase of our senior convertible notes during 2013 and the first quarter of 2014.

Other Income (Expense), Net. Other income (expense), net includes foreign currency transaction gains and losses, gains and losses on investments or asset disposals (excluding disposals of businesses included in discontinued operations), and dividend income. Other income (expense), net was $2.1 million of income compared to $0.3 million of expense for the three months ended September 30, 2014 and 2013, respectively. Other income (expense), net was $1.9 million of income compared to $16.7 million of income for the nine months ended September 30, 2014 and 2013, respectively. The other income, net that was recognized in the three and nine months ended September 30, 2014 was primarily related to additional gains recognized on the sale of a cost method investment that occurred in the first quarter of 2013. These gains were contingent on the release of an escrow amount that occurred in the third quarter of 2014. The other income, net that was recorded for the nine months ended September 30, 2013 was related to the initial gain on the sale of the same cost method investment.

Gain (Loss) on Extinguishment of Debt. During the first quarter of 2014, we repurchased $160.6 million of our 2.00% senior convertible notes in the open market for $164.5 million, excluding accrued interest. The loss on extinguishment of this debt, including the premium on repurchase and acceleration of the recognition of deferred financing fees was $5.5 million. In addition, we repurchased $8.7 million of our 1.25% senior convertible notes at par in the first quarter of 2014 and recorded a $0.1 million charge related to the acceleration of the recognition of deferred financing fees.

Income Tax Expense. For the three months ended September 30, 2014 and 2013, our tax benefit related to continuing operations was $8.3 million and $0.6 million, respectively. For the three months ended September 30, 2014 our tax benefit related to discontinued operations was $0.1 million compared to a tax expense of $2.7 million for the three months ended September 30, 2013. For the three months ended September 30, 2014, our tax benefit related to continuing operations consisted of $8.4 million U.S. tax benefit and $0.1 million of foreign tax expense. For the three months ended September 30, 2013, our tax benefit related to continuing operations consisted of $0.4 million of U.S. tax benefit and $0.2 million of foreign tax benefit. For the three months ended September 30, 2014 and 2013, the tax rate was a benefit of 194.0% and 7.8%, respectively.

For the nine months ended September 30, 2014 and 2013, our tax benefit related to continuing operations was $7.4 million and $0.4 million, respectively. For the nine months ended September 30, 2014, we had no tax expense related to discontinued operations compared to tax expense of $2.5 million for the nine months ended September 30, 2013. For the nine months ended September 30, 2014, our tax expense related to continuing operations consisted of $8.1 million of U.S. tax benefit and $0.8 million of foreign tax expense. For the nine months ended September 30, 2013, our tax expense related continuing operations consisted of $1.0 million of U.S. tax

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expense and $1.4 million of foreign tax benefit. For the nine months ended September 30, 2014 and 2013, the tax rate was 45.0% and 2.2%, respectively.

The tax benefit for both the three and nine month periods ended September 30, 2014 was driven by $9.1 million of previously unrecognized tax benefits, including $1.4 million of related interest, which was released in the third quarter of 2014 due to the expiration of a statute of limitations.

Discontinued Operations. The pre-tax gain related to the disposal of discontinued operations recorded in the three months ended September 30, 2014 was immaterial compared to a pre-tax loss related to the operation of the discontinued entities of $0.1 million and pre-tax loss of $2.1 million related to the disposal of those entities for the three months ended September 30, 2013. Total net gain from discontinued operations was $0.1 million for the three months ended September 30, 2014, compared to a net loss of $4.9 million for the same period in the prior year. The pre-tax gain related to the disposal of discontinued operations recorded in the nine months ended September 30, 2014 was $0.3 million compared to a pre-tax loss of $3.7 million for the nine months ended September 30, 2013, which consists of $1.6 million of pre-tax loss on the operation of the discontinued entities and $2.1 million pre-tax loss on disposal. Total net gain from discontinued operations was $0.3 million for the nine months ended September 30, 2014, compared to a net loss of $6.2 million for the same period in the prior year.

Off Balance Sheet Arrangements

None.

Liquidity and Capital Resources

	Nine Months Ended September 30,	
	2014	2013
Cash provided by (used in):		
Operating activities	$ 8,199	$ (45,555)
Investing activities	(44,875)	5,799
Financing activities	(204,667)	(51,176)
Effect of exchange rate changes on cash and cash equivalents	(9,120)	6,143
Net increase (decrease) in cash and cash equivalents	$ (250,463)	$ (84,789)

As of September 30, 2014, we had $233.4 million of cash and cash equivalents, approximately 63.2% was held by our international subsidiaries. Cash and cash equivalents are sufficient to fund our current and anticipated operations and we do not anticipate any local liquidity restrictions that would preclude us from funding our expansion or operating needs.

Operating Activities

Net cash provided by operations for the nine months ended September 30, 2014, of $8.2 million was due to net add backs for non-cash operating expenses, offset by changes in working capital, a $27.5 million use of cash. Excluding the impact of working capital changes, our operating cash flow for the nine months ended September 30, 2014, was $35.7 million. Net cash used in operations for the nine months ended September 30, 2013, was $45.6 million, and was primarily the result of changes in working capital, a $71.9 million use of cash. Excluding the impact of working capital changes, our operating cash flow for the nine months ended September 30, 2013, was $26.4 million.

Investing Activities

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Net cash used in investing activities for the nine months ended September 30, 2014, was $44.9 million and was the result of net purchases of