

Google Inc.
Form 10-Q
May 09, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007

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: 000-50726

Google Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

1600 Amphitheatre Parkway
Mountain View, CA 94043

77-0493581
(I.R.S. Employer
Identification Number)

Edgar Filing: Google Inc. - Form 10-Q

(Address of principal executive offices)

(Zip Code)

(650) 253-0000

(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 such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

At April 30, 2007, the number of shares outstanding of Google's Class A common stock was 231,472,129 shares and the number of shares outstanding of Google's Class B common stock was 80,075,402 shares.

Table of Contents

GOOGLE INC.

INDEX

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
Item 1	
<u>Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets December 31, 2006 and March 31, 2007 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Income Three Months Ended March 31, 2006 and 2007 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows Three Months Ended March 31, 2006 and 2007 (unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	6
Item 2	16
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
Item 3	29
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	
Item 4	30
<u>Controls and Procedures</u>	
<u>PART II. OTHER INFORMATION</u>	
Item 1	31
<u>Legal Proceedings</u>	
Item 1A	31
<u>Risk Factors</u>	
Item 2	42
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	
Item 6	43
<u>Exhibits</u>	
<u>Signatures</u>	44
<u>Exhibit Index</u>	
Certifications	

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****GOOGLE INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except par value)

	As of December 31, 2006	As of March 31, 2007 (unaudited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,544,671	\$ 4,081,340
Marketable securities	7,699,243	7,854,579
Accounts receivable, net of allowance of \$16,914 and \$18,562	1,322,340	1,477,090
Deferred income taxes, net	29,713	51,259
Prepaid revenue share, expenses and other assets	443,880	616,506
Total current assets	13,039,847	14,080,774
Prepaid revenue share, expenses and other assets, non-current	114,455	129,903
Non-marketable equity securities	1,031,850	1,030,952
Property and equipment, net	2,395,239	2,826,717
Intangible assets, net	346,841	326,526
Goodwill	1,545,119	1,620,566
Total assets	\$ 18,473,351	\$ 20,015,438
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 211,169	\$ 181,828
Accrued compensation and benefits	351,671	180,708
Accrued expenses and other current liabilities	265,872	300,068
Accrued revenue share	370,364	448,121
Deferred revenue	105,136	105,771
Income taxes payable	375	37,857
Total current liabilities	1,304,587	1,254,353
Deferred revenue, long-term	20,006	20,979
Deferred income taxes, net	40,421	18,821
Income taxes payable, long-term		267,209
Other long-term liabilities	68,497	76,866
Commitments and contingencies		
Stockholders' equity:		
Class A and Class B common stock, \$0.001 par value: 9,000,000 shares authorized; 308,997 (Class A 227,670, Class B 81,327) and par value of \$309 (Class A \$228, Class B \$81) and 310,396 (Class A 230,168, Class B 80,228) and par value of \$310 (Class A \$230, Class B \$80) shares issued and outstanding, excluding 1,296 (Class A 1,045, Class B 251) and 973 (Class A 791, Class B 182) shares subject to repurchase at December 31,	309	310

Edgar Filing: Google Inc. - Form 10-Q

2006 and March 31, 2007

Additional paid-in capital	11,882,906	12,211,590
Accumulated other comprehensive income	23,311	36,942
Retained earnings	5,133,314	6,128,368
Total stockholders' equity	17,039,840	18,377,210
Total liabilities and stockholders' equity	\$ 18,473,351	\$ 20,015,438

See accompanying notes.

Table of Contents**GOOGLE INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(in thousands, except per share amounts)**

	Three Months Ended	
	March 31,	March 31,
	2006	2007
	(unaudited)	
Revenues	\$ 2,253,755	\$ 3,663,971
Costs and expenses:		
Cost of revenues (including stock-based compensation expense of \$2,283 and \$4,389)	904,119	1,470,426
Research and development (including stock-based compensation expense of \$73,086 and \$120,787)	246,599	408,384
Sales and marketing (including stock-based compensation expense of \$15,929 and \$27,250)	190,943	302,552
General and administrative (including stock-based compensation expense of \$23,366 and \$31,440)	169,395	261,400
Total costs and expenses	1,511,056	2,442,762
Income from operations	742,699	1,221,209
Interest income and other, net	67,919	130,728
Income before income taxes	810,618	1,351,937
Provision for income taxes	218,327	349,775
Net income	\$ 592,291	\$ 1,002,162
Net income per share of Class A and Class B common stock:		
Basic	\$ 2.02	\$ 3.24
Diluted	\$ 1.95	\$ 3.18

See accompanying notes.

Table of Contents**GOOGLE INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	Three Months Ended	
	2006	March 31, 2007 (unaudited)
Operating activities		
Net income	\$ 592,291	\$ 1,002,162
Adjustments:		
Depreciation and amortization of property and equipment	95,868	170,289
Amortization of intangibles and other	15,290	34,703
In-process research and development	4,000	
Stock-based compensation	114,664	183,866
Excess tax benefits from stock-based award activity	(77,285)	(74,084)
Other		(6,386)
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(155,221)	(153,562)
Income taxes, net	216,527	337,702
Prepaid revenue share, expenses and other assets	(26,525)	(185,478)
Accounts payable	30,232	(29,256)
Accrued expenses and other liabilities	(39,295)	(139,886)
Accrued revenue share	51,216	77,864
Deferred revenue	3,042	1,659
Net cash provided by operating activities	824,804	1,219,593
Investing activities		
Purchases of property and equipment	(344,938)	(596,893)
Purchases of marketable securities	(13,111,471)	(5,225,160)
Maturities and sales of marketable securities	11,755,756	5,079,364
Acquisitions, net of cash acquired, and purchases of intangible and other assets	(187,964)	(34,441)
Net cash used in investing activities	(1,888,617)	(777,130)
Financing activities		
Net proceeds from stock-based award activity	42,611	14,426
Excess tax benefits from stock-based award activity	77,285	74,084
Net cash provided by financing activities	119,896	88,510
Effect of exchange rate changes on cash and cash equivalents	1,922	5,696
Net increase (decrease) in cash and cash equivalents	(941,995)	536,669
Cash and cash equivalents at beginning of year	3,877,174	3,544,671
Cash and cash equivalents at end of period	\$ 2,935,179	\$ 4,081,340

Supplemental disclosures of cash flow information

Edgar Filing: Google Inc. - Form 10-Q

Cash paid for interest	\$	8	\$	342
Cash paid for income taxes	\$	1,126	\$	12,774

See accompanying notes.

Table of Contents

GOOGLE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Google Inc. and Summary of Accounting Policies

Nature of Operations

We were incorporated in California in September 1998. We were re-incorporated in the State of Delaware in August 2003. We provide highly targeted advertising and global internet search solutions as well as intranet solutions via an enterprise search appliance.

Basis of Consolidation

The Condensed Consolidated Financial Statements include the accounts of Google and our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated.

Unaudited Interim Financial Information

The accompanying Condensed Consolidated Balance Sheet as of March 31, 2007, the Condensed Consolidated Statements of Income for the three months ended March 31, 2006 and 2007, and the Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2006 and 2007 are unaudited. These unaudited interim Condensed Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles. In our opinion, the unaudited interim Condensed Consolidated Financial Statements include all adjustments of a normal recurring nature necessary for the fair presentation of our financial position as of March 31, 2007, our results of operations for the three months ended March 31, 2006 and 2007, and our cash flows for the three months ended March 31, 2006 and 2007. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the results to be expected for the year ending December 31, 2007.

These unaudited interim Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements and related notes included in our 2006 Annual Report on Form 10-K filed on March 1, 2007.

Use of Estimates

The preparation of interim Condensed Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the amounts reported and disclosed in the financial statements and the accompanying notes. Actual results could differ materially from these estimates. On an ongoing basis, we evaluate our estimates, including those related to the accounts receivable, fair values of marketable and non-marketable securities, fair values of intangible assets and goodwill, useful lives of intangible assets and property and equipment, fair values of options to purchase our common stock, and income taxes, among others. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. We engage third-party valuation consultants to assist management in the allocation of the purchase price of significant acquisitions.

Effect of Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for us beginning January 1, 2008. We are currently evaluating the impact of the adoption of SFAS No. 157 on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities- including an Amendment of FASB Statement No. 115*, which allows an entity to choose to measure certain financial instruments and liabilities at fair value. Subsequent measurements for the financial instruments and liabilities an entity elects to fair value will be recognized in earnings. SFAS No. 159

Edgar Filing: Google Inc. - Form 10-Q

also establishes additional disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted provided that the entity also adopts SFAS No. 157. We are currently evaluating whether to adopt SFAS No. 159.

Table of Contents**Note 2. Net Income per Share of Class A and Class B common stock**

The following table sets forth the computation of basic and diluted net income per share of Class A and Class B common stock (in thousands, except per share amounts, unaudited):

	For the Three Months Ended			
	2006		2007	
	Class A	Class B	Class A (unaudited)	Class B
Basic net income per share:				
Numerator:				
Allocation of undistributed earnings	\$ 410,663	\$ 181,628	\$ 740,449	\$ 261,713
Denominator:				
Weighted average common shares outstanding	205,894	91,063	229,432	80,994
Less: Weighted average unvested common shares subject to repurchase or cancellation	(2,122)	(939)	(894)	(217)
Number of shares used in per share computations	203,772	90,124	228,538	80,777
Basic net income per share	\$ 2.02	\$ 2.02	\$ 3.24	\$ 3.24
Diluted net income per share:				
Numerator:				
Allocation of undistributed earnings for basic computation	\$ 410,663	\$ 181,628	\$ 740,449	\$ 261,713
Reallocation of undistributed earnings as a result of conversion of Class B to Class A shares	181,628		261,713	
Reallocation of undistributed earnings to Class B shares		(353)		(1,330)
Allocation of undistributed earnings	\$ 592,291	\$ 181,275	\$ 1,002,162	\$ 260,383
Denominator:				
Number of shares used in basic computation	203,772	90,124	228,538	80,777
Weighted average effect of dilutive securities				
Add:				
Conversion of Class B to Class A common shares outstanding	90,124		80,777	
Unvested common shares subject to repurchase or cancellation	3,061	939	399	217
Employee stock options	6,805	2,016	4,314	816
Restricted shares and restricted stock units	361		842	
Number of shares used in per share computations	304,123	93,079	314,870	81,810
Diluted net income per share	\$ 1.95	\$ 1.95	\$ 3.18	\$ 3.18

Certain securities have been excluded from our earnings per share computation because their effect was anti-dilutive. The number of shares excluded was not material in any of the periods presented.

Table of Contents**Note 3. Cash, Cash Equivalents and Marketable Securities**

Cash, cash equivalents and marketable securities consists of the following (in thousands):

	As of December 31, 2006	As of March 31, 2007 (unaudited)
Cash and cash equivalents:		
Cash	\$ 2,996,603	\$ 2,712,325
Cash equivalents:		
U.S. government agencies	323,900	436,273
Time deposits		700,000
Municipal securities	216,529	222,875
Money market funds	7,639	9,867
Total cash and cash equivalents	3,544,671	4,081,340
Marketable securities:		
U.S. government notes	2,697,880	1,944,257
U.S. government agencies	2,839,430	3,378,212
Municipal securities	1,622,570	1,964,803
Time deposits	500,000	500,000
U.S. corporate securities	39,363	67,307
Total marketable securities	7,699,243	7,854,579
Total cash, cash equivalents and marketable securities	\$ 11,243,914	\$ 11,935,919

The following table summarizes unrealized gains and losses related to our investments in marketable securities designated as available-for-sale (in thousands):

	Adjusted Cost	As of December 31, 2006		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
U.S. government notes	\$ 2,704,753	\$ 1,201	\$ (8,074)	\$ 2,697,880
U.S. government agencies	2,838,759	4,081	(3,410)	2,839,430
Municipal securities	1,627,428	197	(5,055)	1,622,570
Time deposits	500,000			500,000
U.S. corporate securities	39,363			39,363
Total marketable securities	\$ 7,710,303	\$ 5,479	\$ (16,539)	\$ 7,699,243

	Adjusted Cost	As of March 31, 2007 (unaudited)		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
U.S. government notes	\$ 1,948,934	\$ 6	\$ (4,683)	\$ 1,944,257

Edgar Filing: Google Inc. - Form 10-Q

U.S. government agencies	3,379,681	1,302	(2,771)	3,378,212
Municipal securities	1,968,204	454	(3,855)	1,964,803
Time deposits	500,000			500,000
U.S. corporate securities	67,308		(1)	67,307
 Total marketable securities	 \$ 7,864,127	 \$ 1,762	 \$ (11,310)	 \$ 7,854,579

Gross unrealized gains and losses on cash equivalents were not material at December 31, 2006 and March 31, 2007. Gross realized gains or losses were not material in the three months ended March 31, 2006 and 2007. There were no other-than-temporary impairments to our marketable securities in the three months ended March 31, 2006 and 2007.

Table of Contents

The following table summarizes the estimated fair value of our investments in marketable securities designated as available-for-sale classified by the contractual maturity date of the security (in thousands):

	As of December 31, 2006	As of March 31, 2007 (unaudited)
Due within 1 year	\$ 3,448,793	\$ 3,291,614
Due after 1 year through 5 years	3,426,600	3,444,074
Due after 5 years through 10 years	57,590	116,058
Due after 10 years	766,260	1,002,833
Total marketable securities	\$ 7,699,243	\$ 7,854,579

In accordance with EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, the following table shows gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2006 and March 31, 2007, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in thousands):

	As of December 31, 2006				Total Unrealized	
	Less than 12 Months Unrealized		12 Months or Greater Unrealized			
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
U.S. government notes	\$ 893,264	\$ (3,339)	\$ 1,138,237	\$ (4,735)	\$ 2,031,501	\$ (8,074)
U.S. government agencies	1,620,106	(2,603)	193,178	(807)	1,813,284	(3,410)
Municipal securities	676,089	(1,473)	248,953	(3,582)	925,042	(5,055)
Total	\$ 3,189,459	\$ (7,415)	\$ 1,580,368	\$ (9,124)	\$ 4,769,827	\$ (16,539)

	As of March 31, 2007 (unaudited)				Total Unrealized	
	Less than 12 Months Unrealized		12 Months or Greater Unrealized			
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
U.S. government notes	\$ 405,530	\$ (449)	1,461,630	\$ (4,234)	\$ 1,867,160	\$ (4,683)
U.S. government agencies	1,421,175	(1,320)	790,894	(1,451)	2,212,069	(2,771)
Municipal securities	534,080	(1,348)	245,575	(2,507)	779,655	(3,855)
U.S. Corporate securities	9,907	(1)			9,907	(1)
Total	\$ 2,370,692	\$ (3,118)	\$ 2,498,099	\$ (8,192)	\$ 4,868,791	\$ (11,310)

Table of Contents**Note 4. Property and Equipment**

Property and equipment consist of the following (in thousands):

	As of December 31, 2006	As of March 31, 2007 (unaudited)
Information technology assets	\$ 1,778,028	\$ 1,994,362
Construction in process	850,164	1,031,550
Land and buildings	352,112	505,841
Leasehold improvements	273,262	306,474
Furniture and fixtures	36,028	38,047
Total	3,289,594	3,876,274
Less accumulated depreciation and amortization	894,355	1,049,557
Property and equipment, net	\$ 2,395,239	\$ 2,826,717

Note 5. Acquisitions

During the three months ended March 31, 2007, we acquired all of the voting interests of two companies. Both of these transactions were accounted for as business combinations. The total initial purchase price for these transactions was \$28.6 million and was paid or will be paid in cash. In addition, we are obligated to make additional cash payments of up to \$8.1 million if certain performance targets are met through 2010. Since these contingent payments are based on the achievement of performance targets, actual payments may be substantially lower. A portion of these contingent payments will be accounted for as goodwill, and the remaining amounts will be expensed, when and if earned.

In addition, during the three months ended March 31, 2007, we acquired certain other intangible assets for \$7.4 million paid in cash.

The following table summarizes the allocation of the purchase price for all of the above acquisitions (in thousands):

Goodwill	\$ 22,580
Patents and developed technology	15,067
Customer contracts and other	1,100
Net assets acquired	226
Deferred tax liabilities	(3,012)
Total	\$ 35,961

The developed technology, customer contracts and other intangible assets have a weighted-average useful life of 2.8 years from the date of acquisition. A majority of the amortization of these intangibles assets is not deductible for tax purposes. Goodwill is not deductible for tax purposes for one of the purchases.

Note 6. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the three months ended March 31, 2007, are as follows (in thousands):

Balance as of December 31, 2006	\$ 1,545,119
---------------------------------	--------------

Edgar Filing: Google Inc. - Form 10-Q

Goodwill acquired	22,580
Goodwill adjustment	52,867
Balance as of March 31, 2007	\$ 1,620,566

The goodwill adjustment of \$52.9 million was primarily a result of an increase to an estimate of employee termination costs and a contingent payment earned upon the achievement of certain performance targets related to business combinations initially recorded in 2006.

Table of Contents

Information regarding our acquisition-related intangible assets that are being amortized is as follows (in thousands):

	As of December 31, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Patents and developed technology	\$ 241,185	\$ 95,927	\$ 145,258
Tradenames, customer contracts and other	244,357	42,774	201,583
Total	\$ 485,542	\$ 138,701	\$ 346,841

	As of March 31, 2007 (unaudited)		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Patents and developed technology	\$ 256,252	\$ 113,416	\$ 142,836
Tradenames, customer contracts and other	245,624	61,934	183,690
Total	\$ 501,876	\$ 175,350	\$ 326,526

Patents and developed technology and tradenames, customer contracts and other have weighted-average useful lives from the date of purchase of 3.2 and 4.1 years. Amortization expense of acquisition-related intangible assets for the three months ended March 31, 2006 and March 31, 2007 was \$15.4 million and \$36.3 million.

Amortization expense for acquisition-related intangible assets on our March 31, 2007 Condensed Consolidated Balance Sheet for the remainder of 2007 and each of the next four years and thereafter is as follows (in thousands):

Remainder of 2007	\$ 94,170
2008	106,095
2009	61,134
2010	40,092
2011	24,222
Thereafter	813
	\$ 326,526

Note 7. Interest Income and Other, Net

The components of interest income and other, net were as follows (in thousands):

	Three Months Ended	
	March 31, 2006	March 31, 2007 (unaudited)
Interest income	\$ 78,924	\$ 130,475
Interest expense	(8)	(342)
Other	(10,997)	595

Interest income and other, net

\$ 67,919

\$ 130,728

Note 8. Contingencies

Legal Matters

Companies have filed trademark infringement and related claims against us over the display of ads in response to user queries that include trademark terms. The outcomes of these lawsuits have differed from jurisdiction to jurisdiction. Courts in France have held us liable for allowing advertisers to select certain trademarked terms as keywords. We are appealing those decisions. We were also subject to two lawsuits in Germany on similar matters where the courts held that we are not liable for the actions of our advertisers prior to notification of trademark rights. We are litigating or have recently litigated similar issues in other cases in the U.S., France, Germany, Israel, Italy and Austria.

We have also had copyright claims filed against us alleging that features of certain of our products and services, including Google Web Search, Google News, Google Video, Google Image Search, Google Book Search and YouTube, infringe their rights.

Table of Contents

Adverse results in these lawsuits may include awards of substantial monetary damages, costly royalty or licensing agreements or orders preventing us from offering certain functionalities, and may also result in a change in our business practices, which could result in a loss of revenue for us or otherwise harm our business. In addition, any time one of our products or services links to or hosts material in which others allegedly own copyrights, we face the risk of being sued for copyright infringement or related claims. Because these products and services comprise the majority of our products and services, the risk of harm from such lawsuits could be substantial.

From time to time, we may also become a party to other litigation and subject to claims incident to the ordinary course of business, including intellectual property claims (in addition to the trademark and copyright matters noted above), labor and employment claims, breach of contract claims, tax and other matters.

Although the results of litigation and claims cannot be predicted with certainty, we believe that the final outcome of the matters discussed above will not have a material adverse effect on our business, consolidated financial position, results of operations or cash flows.

Income Taxes

We are currently under audit by the Internal Revenue Service and various other tax authorities. We have reserved for potential adjustments to our provision for income taxes that may result from examinations by, or any negotiated agreements with, these tax authorities, and we believe that the final outcome of these examinations or agreements will not have a material effect on our results of operations. If events occur which indicate payment of these amounts is unnecessary, the reversal of the liabilities would result in the recognition of tax benefits in the period we determine the liabilities are no longer necessary. If our estimates of the federal, state, and foreign income tax liabilities are less than the ultimate assessment, a further charge to expense would result.

Note 9. Stockholders Equity

The following table presents the weighted-average assumptions used to estimate the fair values of the stock options granted in the periods presented:

	Three Months Ended	
	March 31, 2006 (unaudited)	2007
Risk-free interest rate	4.63%	4.64%
Expected volatility	40%	30%
Expected life (in years)	3.1	3.4
Dividend yield		
Weighted-average estimated fair value of options granted during the period	\$ 128.21	\$ 130.77

The following table summarizes the activity for outstanding stock options for the three months ended March 31, 2007:

	Number of Shares	Options Outstanding		Aggregate Intrinsic Value (in millions) (1)
		Weighted- Average Exercise Price (unaudited)	Weighted- Average Remaining Contractual Term (in years)	
Balance at December 31, 2006	13,424,872	\$ 205.58		
Granted	508,307	\$ 462.33		
Exercised/vested	(1,266,021)	\$ 39.21		
Canceled/forfeited/expired	(78,787)	\$ 213.18		

Edgar Filing: Google Inc. - Form 10-Q

Balance at March 31, 2007	12,588,371	\$	230.47	8.0	\$ 2,644.4
Vested and exercisable as of March 31, 2007	2,999,907	\$	136.08	7.2	\$ 966.2
Vested and expected to vest as of March 31, 2007	12,044,705	\$	229.02	8.0	\$ 2,549.2

- (1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the closing stock price of \$458.16 of our Class A common stock on March 30, 2007.

Table of Contents

Options outstanding at March 31, 2007 includes 972,953 options granted and exercised subsequent to March 21, 2002 that are unvested at March 31, 2007, in accordance with EITF Issue No. 00-23, *Issues Related to Accounting for Stock Compensation Under APB Opinion No. 25 and FASB Interpretation No. 44* (EITF 00-23). However, the computations of the weighted-average exercise prices, weighted average remaining contractual term and aggregate intrinsic value for all stock options outstanding and those exercisable do not consider these unvested shares. The aggregate intrinsic value of all options exercised during the three months ended March 31, 2007 was \$398.7 million. The total grant date fair value of stock options vested during the three months ended March 31, 2007 was \$146.2 million.

As of March 31, 2007, there was \$787.4 million of unrecognized compensation cost related to employee outstanding stock options, net of forecasted forfeitures. This amount is expected to be recognized over a weighted average period of 2.4 years. To the extent the forfeiture rate is different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

The following table summarizes the activity for our unvested restricted stock units for the three months ended March 31, 2007:

	Unvested Restricted Stock Units Weighted-Average	
	Number of Shares	Grant- Date
		Fair Value (unaudited)
Unvested at December 31, 2006	1,771,037	\$ 369.54
Granted	303,668	\$ 463.26
Vested	(123,351)	\$ 373.20
Forfeited	(17,587)	\$ 415.21
Unvested at March 31, 2007	1,933,767	\$ 384.08
Expected to vest at March 31, 2007	1,824,122	\$ 384.08

As of March 31, 2007, there was \$601.0 million of unrecognized compensation cost related to unvested restricted stock units, net of forecasted forfeitures. This amount is expected to be recognized over a weighted average period of 3.0 years. To the extent the actual forfeiture rate is different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

The following table summarizes additional information regarding outstanding, exercisable and exercisable and vested stock options at March 31, 2007:

Range of Exercise Prices	Total Number of Shares	Options Outstanding			Options Exercisable		Options Exercisable and Vested		
		Unvested Options Granted and Exercised Subsequent to March 21, 2002	Number of Shares	Weighted-Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
\$ 0.08 \$ 85.00	4,745,644	972,953	3,772,691	6.5	\$ 18.55	3,664,275	\$ 18.26	1,519,100	\$ 12.28
\$117.84 \$198.41	1,843,387		1,843,387	7.8	\$ 176.15	522,498	\$ 174.91	522,488	\$ 174.91
\$205.96 \$298.91	1,467,200		1,467,200	8.2	\$ 274.12	408,003	\$ 274.69	408,003	\$ 274.69
\$300.97-\$399.00	1,910,781		1,910,781	8.6	\$ 329.07	453,757	\$ 318.91	453,757	\$ 318.91
\$401.78 \$499.07	1,269,496		1,269,496	9.5	\$ 444.58	95,059	\$ 427.40	95,059	\$ 427.40
\$501.50 \$508.01	1,351,863		1,351,863	9.7	\$ 507.94	1,500	\$ 508.01	1,500	\$ 508.01
\$ 0.08 \$508.01	12,588,371	972,953	11,615,418	8.0	\$ 230.44	5,145,092	\$ 88.72	2,999,907	\$ 136.08

Edgar Filing: Google Inc. - Form 10-Q

The number of options outstanding at March 31, 2007 includes 972,953 of options granted and exercised subsequent to March 21, 2002 that are unvested at March 31, 2007, in accordance with EITF 00-23. However, the computations of the weighted-average exercise prices and the weighted average remaining life in the table above do not consider these unvested shares.

Table of Contents**Note 10. Income Taxes**

Effective January 1, 2007, we adopted the provisions of Financial Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109 and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. As a result of the implementation of FIN 48, we recognized a \$7.1 million increase in the liability for unrecognized tax benefits related to tax positions taken in prior periods. This increase was accounted for as an adjustment to retained earnings in accordance with the provisions of the statement. Additionally, we reclassified \$219.4 million from current taxes payable to long-term taxes payable.

Upon adoption of FIN 48, our policy to include interest and penalties related to gross unrecognized tax benefits within our provision for income taxes did not change. As of March 31, 2007, we had accrued \$11.7 million for payment of such interest and penalties. Interest and penalties included in our provision for income taxes were not material in the three months ended March 31, 2006 and 2007.

Our total unrecognized tax benefits as of January 1, 2007 (the date of adoption) and March 31, 2007 was \$243.6 million and \$292.1 million. Also, our total unrecognized tax benefits that, if recognized, would affect our effective tax rate were \$195.7 million and \$223.9 million as of January 1, 2007 and March 31, 2007.

Although we file U.S. federal, U.S. state, and foreign tax returns, our two major tax jurisdictions are the U.S. and Ireland. Our 2003–2006 tax years remain subject to examination by the IRS for U.S. federal tax purposes, and our 2002–2006 tax years remain subject to examination by the appropriate governmental agencies for Irish tax purposes. Currently, we are under examination by the IRS for our 2003 and 2004 tax years.

Note 11. Information about Geographic Areas

Our chief operating decision-makers (i.e., our chief executive officer, his direct reports and our presidents) review financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by geographic region for purposes of allocating resources and evaluating financial performance. There are no segment managers who are held accountable by our chief operating decision-makers, or anyone else, for operations, operating results and planning for levels or components below the consolidated unit level. Accordingly, we consider ourselves to be in a single reporting segment and operating unit structure.

Revenues by geography are based on the billing addresses of the advertisers. The following table sets forth revenues and long-lived assets by geographic area (in thousands):

	Three Months Ended	
	March 31, 2006 (unaudited)	March 31, 2007 (unaudited)
Revenues:		
United States	\$ 1,317,521	\$ 1,958,382
United Kingdom	342,871	578,359
Rest of the world	593,363	1,127,230
Total revenues	\$ 2,253,755	\$ 3,663,971
	As of December 31, 2006	As of March 31, 2007 (unaudited)
Long-lived assets:		
United States	\$ 5,070,694	\$ 5,540,153
International	362,810	394,511

Edgar Filing: Google Inc. - Form 10-Q

Total long-lived assets

\$ 5,433,504 \$ 5,934,664

Table of Contents

Note 12. Subsequent Events

Agreement and Plan of Merger with DoubleClick

In April 2007, we entered into an Agreement and Plan of Merger with DoubleClick to acquire all of the outstanding interests of DoubleClick, a privately held company, for \$3.1 billion in cash, plus the cash and cash equivalents of DoubleClick, plus the aggregate exercise price for outstanding options and stock appreciation rights for DoubleClick common stock, as well as certain other adjustments, minus certain unpaid third party expenses incurred by DoubleClick in connection with this transaction and minus all indebtedness for borrowed money of DoubleClick.

In addition, unvested options and stock appreciation rights of DoubleClick will be converted into options to purchase our common stock with economic terms similar to outstanding vested equity interests.

The completion of this transaction is subject to various customary conditions, including termination or expiration of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act and receipt of certain foreign antitrust approvals and clearances. We and DoubleClick have each agreed to take all actions necessary to obtain the requisite antitrust and other regulatory approvals.

Transferable Stock Options Program

In April 2007, we launched our employee transferable stock option (TSO) program. Under the TSO program, certain employees are able to sell vested options granted under our 2004 Stock Plan to selected financial institutions in an online auction. All employees may sell under the program other than our executive management group and those that reside in countries where, due to local legal and/or tax implications, it would not be beneficial to employees or the TSO program would be impractical. All eligible outstanding options were modified in the second quarter of 2007 to allow selling under the TSO program and, as a result, we will incur a modification charge of approximately \$70 million in the second quarter of 2007 related to vested options as of the end of that quarter and a charge of approximately \$160 million over their remaining vesting periods of up to approximately four years related to unvested options. The modification charge is equal to the difference between the values of those modified stock options on the date of modification and their values immediately prior to modification in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment*. Further, to the extent the forfeiture rate is different than we have anticipated, the modification charge related to these awards will be different from our expectations.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In addition to historical information, this report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements include, among other things, statements concerning our expectations:

regarding the growth of our operations, business and revenues and the growth rate of our costs and expenses;

that seasonal fluctuations in internet usage and traditional advertising seasonality are likely to affect our business;

that growth in advertising revenues from our web sites will continue to exceed that from our Google Network members' web sites;

that our operating margin may decrease as we invest in our employee, systems infrastructures and property and equipment;

regarding our future stock-based compensation charges;

regarding any stock-based compensation charges associated with the modifications to outstanding options that are eligible for sale in the TSO program;

that we will continue to pay most of the Google AdSense fees we receive from advertisers to our Google Network members;

regarding our future fee structure for our Google Checkout product offering;

that we will continue to make significant capital expenditure investments in 2007;

that our cost of revenues will increase in 2007 primarily as a result of anticipated increases in traffic acquisition and data center costs;

that research and development, sales and marketing and general and administrative expenses will increase in the future;

regarding the sufficiency of our existing cash, cash equivalents, marketable securities and cash generated from operations; as well as other statements regarding our future operations, financial condition and prospects and business strategies. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this report, and in particular, the risks discussed under the heading "Risk Factors" in Part I, Item 1A of this report and those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

The following discussion and analysis of our financial condition and results of operations should be read together with our Condensed Consolidated Financial Statements and related notes included elsewhere in this report.

Edgar Filing: Google Inc. - Form 10-Q

Overview

Google is a global technology leader focused on improving the ways people connect with information. Our innovations in web search and advertising have made our web site a top internet destination and our brand one of the most recognized in the world. Our mission is to organize the world's information and make it universally accessible and useful. We serve three primary constituencies:

Users. We provide users with products and services that enable people to more quickly and easily find, create and organize information that is useful to them.

Advertisers. We provide advertisers with several ways to deliver relevant targeted advertising including:

Google AdWords, an auction-based advertising program that enables advertisers to deliver relevant ads targeted to search results or web content.

Google Audio Ads, an automated online media platform that schedules and places advertising into radio programs.

Google Print Ads, a web-based marketplace for placing ads in print media.

Google Video Ads, user-initiated click-to-play video ads that run on sites that are part of the Google Network.

Table of Contents

These advertising programs provide advertisers with a cost-effective way to deliver ads to customers across Google sites and through the Google Network, which is the network of online and offline third parties that use our advertising programs to deliver relevant ads with the content they provide.

Content Providers. We provide the online and offline members of our Google Network with our Google AdSense programs, including programs through which we distribute our advertisers' AdWords ads for display on the web sites of our Google Network members as well as programs to deliver audio ads on radio broadcasts and print ads for display in newspapers and magazines. We share most of the fees these ads generate with our Google Network members, thereby creating an important revenue stream for them. In addition, we have entered into arrangements with certain rights holders under which we distribute or license their video and other content. In a few of these arrangements we display ads on the pages of our web sites from which the content is viewed and share most of the fees these ads generate with the rights holders.

Recent Development

In April 2007, we entered into an Agreement and Plan of Merger with DoubleClick to acquire all of the outstanding interests of DoubleClick, a privately held company, for \$3.1 billion in cash, plus the cash and cash equivalents of DoubleClick, plus the aggregate exercise price for outstanding options and stock appreciation rights for DoubleClick common stock, as well as certain other adjustments, minus certain unpaid third party expenses incurred by DoubleClick in connection with this transaction and minus all indebtedness for borrowed money of DoubleClick.

In addition, unvested options and stock appreciation rights of DoubleClick will be converted into options to purchase our common stock with economic terms similar to outstanding vested equity interests.

The completion of this transaction is subject to various customary conditions, including termination or expiration of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act and receipt of certain foreign antitrust approvals and clearances. We and DoubleClick have each agreed to take all actions necessary to obtain the requisite antitrust and other regulatory approvals. This transaction is expected to close by December 31, 2007.

How We Generate Revenue

We derive most of our revenues from fees we receive from our advertisers through our AdWords and AdSense programs.

Google AdWords is our automated online program that enables advertisers to place targeted text-based and display ads on our web sites. AdWords customers originally paid us based on the number of times their ads appeared on users' search results pages. In the first quarter of 2002, we began offering AdWords on a cost-per-click basis, which means that an advertiser pays us only when a user clicks on one of its ads. AdWords is also available through our direct sales force. Effective beginning the first quarter of 2004 until the end of the first quarter of 2005, the AdWords cost-per-click pricing structure was the only pricing structure available to our advertisers. However, during the second quarter of 2005, we launched an AdWords cost-per-impression program that enables advertisers to pay us based on the number of times their ads appear on Google Network members' sites specified by the advertiser. For advertisers using our AdWords cost-per-click pricing, we recognize as revenue the fees charged advertisers each time a user clicks on one of the ads that appears next to the search results on our web sites, or next to the search results or content on Google Network members' sites. For advertisers using our AdWords cost-per-impression pricing, we recognize as revenue the fees charged advertisers each time their ads are displayed on the Google Network members' sites. Our AdWords agreements are generally terminable at any time by our advertisers.

Google AdSense is the program through which we distribute our advertisers' AdWords ads for display on the web sites of our Google Network members. Our AdSense program includes AdSense for search and AdSense for content. AdSense for search, launched in the first quarter of 2002, is our service for distributing relevant ads from our advertisers for display with search results on our Google Network members' sites. To use AdSense for search, most of our AdSense for search partners add Google search functionality to their web pages in the form of customizable Google search boxes. When visitors of these web sites search either the web site or the internet using these customizable search boxes, we display relevant ads on the search results pages, targeted to match user search queries. Ads shown through AdSense for search are generally text ads.

AdSense for content, launched in the first quarter of 2003, is our service for distributing ads from our advertisers that are relevant to content on our Google Network members' sites. Under this program, we use automated technology to analyze the meaning of the content on the web site and serve relevant ads based on the meaning of such content. For example, a web page on an automotive blog that contains an entry about

Edgar Filing: Google Inc. - Form 10-Q

vintage cars might display ads for vintage car parts or vintage car shows. These ads are displayed in spaces that our AdSense for content partners have set aside on their web sites for our AdWords content. AdSense for content allows a variety of ad types to be shown, including text ads, image ads, Google Video Ads, link units (which are sets of clickable links to topic pages related to page content) and themed units (which are regular text ads with graphic treatments that change seasonally and by geography).

Table of Contents

For our AdSense program, our advertisers pay us a fee each time a user clicks on one of our advertisers' ads displayed on Google Network members' web sites or, for those advertisers who choose our cost-per-impression pricing, as their ads are displayed. To date, we have paid most of these advertiser fees to the members of the Google Network, and we expect to continue doing so for the foreseeable future. We recognize these advertiser fees as revenue and the portion of the advertiser fee we pay to our Google Network members as traffic acquisition costs under cost of revenues. In some cases, we guarantee our Google Network members minimum revenue share payments. Members of the Google Network do not pay any fees associated with the use of our AdSense program on their web sites.

Our agreements with Google Network members consist largely of uniform online click-wrap agreements that members enter into by interacting with our registration web sites. The standard agreements have no stated term and are terminable at will. Agreements with our larger members are individually negotiated. Both the standard agreements and the negotiated agreements contain provisions requiring us to share with the Google Network member most of the advertiser fees generated by users clicking on ads on the Google Network member's web site or, for advertisers who choose our cost-per-impression pricing, as the ads are displayed on the Google Network member's web site.

In the third quarter of 2005, we launched our Google Print Ads program through which we distribute our advertisers' ads for publication in print media. We recognize as revenue the fees charged advertisers when their ads are published in magazines. Also, in the first quarter of 2006, we acquired dMarc Broadcasting, Inc. (dMarc), a digital solutions provider for the radio broadcast industry and launched our Google Audio Ads program, which distributes our advertisers' ads for broadcast in radio programs. We recognize as revenue the fees charged advertisers each time an ad is broadcasted or a listener responds to that ad. We consider the magazines and radio stations that participate in these programs to be members of our Google Network.

Advertising revenues made up 99% of our revenues in the three months ended March 31, 2006 and 2007. We derive the balance of our revenues from the license of our web search technology, the license of our search solutions to enterprises and the sale and license of other products and services.

In the first quarter of 2006, we launched Google Video through which we make video content owned by others available for download and purchase by end users. We recognize as revenue the fees we receive from end users to the extent we are the primary obligor to them. However, to the extent we are not the primary obligor, we recognize as revenues the fees we receive from the end users net of the amounts we pay to our video content providers.

Also in the second quarter of 2006, we launched Google Checkout, an online shopping payment processing system for both consumers and merchants. We offer the Google Checkout service to merchants at no charge for sales up to ten times the amount they spend on AdWords advertising per month. We have also announced that we do not plan to charge merchants any fees associated with the use of Google Checkout for 2007. Beginning January 1, 2008, we plan to charge merchants who use Google Checkout to process sales 2% of the transaction amount plus \$0.20 per transaction to the extent the gross merchandise value related to the total fees to be charged to such merchant in a month exceeds 10 times the amount they spend on AdWords advertising in that month. We recognize as revenue any fees charged merchants on transactions processed through Google Checkout. Further, cash ultimately paid to merchants under Google Checkout promotions, including cash paid to merchants as a result of discounts provided to consumers on certain transactions processed through Google Checkout, are accounted for as an offset to revenues.

In the fourth quarter of 2006, we acquired YouTube, a consumer media company for people to watch and share original videos worldwide through a web experience. We recognize as revenue the fees charged advertisers each time an ad is displayed on the YouTube site.

We believe the factors that influence the success of our advertising programs include the following:

The relevance, objectivity and quality of our search results.

The number and type of searches initiated at our web sites.

The number and type of searches initiated at, as well as the number of visits to and the content of, our Google Network members' web sites.

Edgar Filing: Google Inc. - Form 10-Q

The advertisers' return on investment (ad cost per sale or cost per conversion) from advertising campaigns on our web sites or our Google Network members' web sites or other media compared to other forms of advertising.

The number of advertisers and the breadth of items advertised.

The total and per click or per impression advertising spending budgets of each advertiser.

The monetization of (or generation of revenue from) traffic on our web sites and our Google Network members' web sites.

We believe that the monetization of traffic on our web sites, and our Google Network members' web sites is affected by the following factors:

The relevance and quality of ads displayed with each search results page on our web sites and our Google Network members' web sites, as well as with each content page on our Google Network members' web sites, including the relevance and quality of an ad's landing page or page a user views after an ad is clicked.

Table of Contents

The number and prominence of ads displayed with each search results page on our web sites and our Google Network members' web sites, as well as with each content page on our Google Network members' web sites.

The rate at which our users and users of our Google Network members' web sites click on advertisements.

Our minimum fee per click.

Trends in Our Business

Our business has grown rapidly since inception, resulting in substantially increased revenues, and we expect that our business will continue to grow. However, our revenue growth rate has generally declined over time, and we expect it will continue to do so as a result of increasing competition and the difficulty of maintaining growth rates as our revenues increase to higher levels. In addition, the main focus of our advertising programs is to provide relevant and useful advertising to our users, reflecting our commitment to constantly improve their overall web experience. As a result, we may take steps to improve the relevance of the ads displayed on our web sites, such as removing ads that generate low click-through rates or that send users to irrelevant or otherwise low quality sites, which could negatively affect our near-term advertising revenues.

Both seasonal fluctuations in internet usage and traditional retail seasonality have affected, and are likely to continue to affect, our business. Internet usage generally slows during the summer months, and commercial queries typically increase significantly in the fourth quarter of each year. These seasonal trends have caused and will likely continue to cause, fluctuations in our quarterly results, including fluctuations in sequential revenue growth rates.

From the inception of the Google Network in 2002 through the first quarter of 2004, the growth in advertising revenues from our Google Network members' web sites exceeded that from our web sites, which had a negative impact on our operating margins. The operating margin we realize on revenues generated from ads placed on our Google Network members' web sites through our AdSense program is significantly lower than the operating margin we realize from revenues generated from ads placed on our web sites because most of the advertiser fees from ads served on Google Network member web sites are shared with our Google Network members. However, beginning in the second quarter of 2004, growth in advertising revenues from our web sites has exceeded that from our Google Network members' web sites. This trend has had a positive impact on our operating margins and we expect that this will continue for the foreseeable future, although the relative rate of growth in revenues from our web sites compared to the rate of growth in revenues from our Google Network members' web sites may vary over time.

We are heavily investing in building the necessary employee and systems infrastructures required to manage our growth and develop and promote our products and services, and this may cause our operating margins to decrease. We have experienced and expect to continue to experience substantial growth in our operations as we build our research and development programs, expand our base of users, advertisers and Google Network members and increase our presence in international markets. In addition, we are incurring significant costs and expenses to promote the distribution of certain products, including the Google Toolbar, and promote the adoption of Google Checkout by merchants and consumers. Our headcount growth has required us to make substantial investments in property and equipment. Our full-time employee headcount has significantly increased over the last 12 months, growing from 6,790 at March 31, 2006 to 12,238 at March 31, 2007, and we also employ a significant number of temporary employees. In addition, our capital expenditures have grown from \$344.9 million in the three months ended March 31, 2006 to \$596.9 million in the three months ended March 31, 2007. We expect to continue to make significant capital expenditure investments in 2007, including information and technology infrastructure and corporate facilities. In addition, in April 2007, we launched our employee transferable stock option (TSO) program. As a result of the modification of certain options to allow for selling under the program, we will incur a charge of approximately \$70 million in the second quarter of 2007 and a charge of approximately \$160 million over approximately the next four years. In addition, the fair value of each option granted under the TSO program will be greater than it would have been otherwise because of a longer expected life, resulting in more stock-based compensation per option. As a result, the growth rate of our costs and expenses may exceed the growth rate of our revenues in 2007.

We expect our cost of revenues to continue to increase in dollars and may increase as a percentage of revenues in 2007 and in future periods, primarily as a result of forecasted increases in traffic acquisition costs, data center costs and credit card and other transaction fees, including transaction processing fees related to Google Checkout. In particular, traffic acquisition costs as a percentage of advertising revenues may increase in the future if we are unable to continue to improve the monetization of traffic on our web sites and our Google Network members' web sites, particularly with those members to whom we have guaranteed minimum revenue share or other payments.

Our international revenues have grown as a percentage of our total revenues to 47% in the three months ended March 31, 2007 from 44% in the three months ended December 31, 2006 and from 42% in the three months ended March 31, 2006. This increase in the portion of our revenues

Edgar Filing: Google Inc. - Form 10-Q

derived from international markets results largely from increased acceptance of our advertising programs, increases in our direct sales resources and customer support operations and our continued progress in developing localized versions of our products in these international markets.

Results of Operations

The following is a more detailed discussion of our financial condition and results of operations for the periods presented.

Table of Contents

The following table presents our historical operating results as a percentage of revenues for the periods indicated (unaudited):

	March 31, 2006	Three Months Ended December 31, 2006	March 31, 2007
Consolidated Statements of Income Data:			
Revenues	100.0%	100.0%	100.0%
Costs and expenses:			
Cost of revenues	40.1	40.0	40.1
Research and development	10.9	12.1	11.1
Sales and marketing	8.5	8.0	8.3
General and administrative	7.5	6.8	7.2
Total costs and expenses	67.0	66.9	66.7
Income from operations	33.0	33.1	33.3
Interest income and other, net	3.0	3.9	3.6
Income before income taxes	36.0	37.0	36.9
Provision for income taxes	9.7	4.8	9.5
Net income	26.3%	32.2%	27.4%

Revenues

The following table presents our revenues, by revenue source, for the periods presented (in millions, unaudited):

	March 31, 2006	Three Months Ended December 31, 2006	March 31, 2007
Advertising revenues:			
Google web sites	\$ 1,297.3	\$ 1,977.0	\$ 2,282.1
Google Network web sites	928.4	1,197.9	1,345.4
Total advertising revenues	2,225.7	3,174.9	3,627.5
Licensing and other revenues	28.1	30.6	36.5
Revenues	\$ 2,253.8	\$ 3,205.5	\$ 3,664.0

The following table presents our revenues, by revenue source, as a percentage of total revenues for the periods presented (unaudited):

	March 31, 2006	Three Months Ended December 31, 2006	March 31, 2007
Advertising revenues:			
Google web sites	58%	62%	62%
Google Network web sites	41	37	37

Edgar Filing: Google Inc. - Form 10-Q

Total advertising revenues	99	99	99
<i>Google web sites as % of advertising revenues</i>	58	62	63
<i>Google Network web sites as % of advertising revenues</i>	42	38	37
Licensing and other revenues	1%	1%	1%

Growth in our revenues in the three months ended March 31, 2007 compared to the three months ended March 31, 2006 and the three months ended December 31, 2006 resulted primarily from growth in advertising revenues. Our advertising revenue growth for Google web sites and Google Network web sites resulted primarily from increases in the total number of paid clicks and ads displayed through our programs, rather than from changes in the average fees paid by our advertisers. The increase in the number of paid clicks and ads displayed through our programs was due to an increase in aggregate traffic both on our web sites and those of our Google Network members, certain improvements in the monetization of increased traffic on our web sites and our Google Network member sites, the continued global expansion of our products, our advertiser base and our user base, as well as an increase in the number of Google Network members and distribution partners. Improvements in our ability to monetize this increased traffic

Table of Contents

primarily relate to providing our end users with ads that are more relevant to their search queries or to the content on the Google Network members' sites they visit. These improvements have included, for instance, enhancements to the accuracy of our quality scoring, which is our measurement of an ad's quality.

Our sequential quarterly revenue growth rate decreased from 19.2% for the three months ended December 31, 2006, to 14.3% for the three months ended March 31, 2007.

The sequential quarterly revenue growth rate from our web sites decreased from 21.6% for the three months ended December 31, 2006, to 15.4% for the three months ended March 31, 2007. The sequential quarterly revenue growth rate from our Google Network members' web sites decreased from 15.5% for the three months ended December 31, 2006, to 12.3% for the three months ended March 31, 2007. These decreases in the sequential quarterly revenue growth rates are primarily the result of our higher revenue levels and seasonal slowdowns in internet usage and commercial queries. The sequential quarterly revenue growth from our web sites has been greater than that from our Google Network members' web sites primarily as a result of a greater increase in the total number of paid clicks on our web sites, which was largely due to higher traffic growth and monetization improvements. We expect that our revenue growth rates will generally decline in the future as a result of increasing competition and the difficulty of maintaining growth rates as our revenues increase to higher levels.

Aggregate paid clicks on our web sites and our Google Network members' web sites increased approximately 13% from the three months ended December 31, 2006 to the three months ended March 31, 2007, and approximately 52% from the three months ended March 31, 2006 to the three months ended March 31, 2007. In general, these increases in paid clicks have historically correlated with increases in our revenues. However, the rate of increase in paid clicks, and its correlation with the rate of increase in revenues, may fluctuate from quarter to quarter based on various factors including seasonality, advertiser competition for keywords and the revenue growth rates on our web sites compared to those of our Google Network members. In addition, traffic growth in emerging markets compared to more mature markets and across various advertising verticals also contributes to these fluctuations.

We believe that the increase in the number of paid clicks and ads displayed through our programs is the result of our commitment to improving the relevance and quality of both our search results and the advertisements displayed, which we believe results in a better user experience, which in turn results in more searches, advertisers, and Google Network members and other partners. Revenues realized through the Google Print Ads Program, Google Audio Ads, Google Video, Google Checkout and YouTube were not material in any of the periods presented.

Revenues by Geography

Domestic and international revenues as a percentage of consolidated revenues, determined based on the billing addresses of our advertisers, are set forth below (unaudited):

	March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
United States	58%	56%	53%
United Kingdom	15%	15%	16%
Rest of the world	27%	29%	31%

The growth in international revenues in the three months ended March 31, 2007 compared to the three months ended December 31, 2006 and the three months ended March 31, 2006 resulted largely from increased acceptance of our advertising programs, increases in our direct sales resources and customer support operations in international markets and our continued progress in developing localized versions of our products for these international markets. Furthermore, the growth in international revenues from the three months ended December 31, 2006 to the three months ended March 31, 2007 also results from seasonally stronger traffic and monetization in the United Kingdom and certain other countries compared to the U.S.

In addition, the weakening of the U.S. dollar relative to other foreign currencies (primarily the euro and the British pound) in the three months ended March 31, 2007, compared to the three months ended December 31, 2006 had a favorable impact on our international revenues. Had foreign exchange rates remained constant in these periods, our revenues would have been approximately \$22.8 million or 0.6% lower. The weakening of the U.S. dollar relative to other foreign currencies (primarily the euro and the British pound) in the three months ended March 31, 2007 compared to the three months ended March 31, 2006 had a favorable impact on our international revenues. Had foreign exchange rates remained constant in these periods, our revenues would have been approximately \$115.0 million or 3.1% lower.

Table of Contents

While international revenues in each of the periods presented accounted for less than half of our total revenues, more than half of our user traffic during these periods came from outside the U.S. Although we expect to continue to make investments in international markets, they may not result in an increase in our international revenues as a percentage of total revenues in 2007 or thereafter. See Note 11 of Notes to Condensed Consolidated Financial Statements included as part of this Form 10-Q for additional information about geographic areas.

Costs and Expenses

Cost of Revenues.

Cost of revenues consists primarily of traffic acquisition costs. Traffic acquisition costs consist of amounts ultimately paid to our Google Network members under AdSense arrangements and to certain other partners (our distribution partners) who distribute our toolbar and other products (collectively referred to as access points) or otherwise direct search queries to our web site (collectively referred to as distribution arrangements). These amounts are primarily based on the revenue share arrangements with our Google Network members and distribution partners. Certain distribution arrangements require us to pay our partners based on a fee per access point delivered and not exclusively or at all based on revenue share. We recognize fees under these arrangements over the estimated useful lives of the access points (two years) to the extent we can reasonably estimate those lives or based on any contractual revenue share, if greater. Otherwise, the fees are charged to expense as incurred.

In addition, certain AdSense agreements obligate us to make guaranteed minimum revenue share payments to Google Network members based on their achieving defined performance terms, such as number of search queries or advertisements displayed. We amortize guaranteed minimum revenue share prepayments (or accrete an amount payable to a Google Network member if the payment is due in arrears) based on the number of search queries or advertisements displayed on the Google Network member's web site or the actual revenue share amounts, whichever is greater. In addition, concurrent with the commencement of a small number of AdSense and other agreements, we have purchased certain items from, or provided other consideration to, our Google Network members and partners. We have determined that certain of these amounts are prepaid traffic acquisition costs and are amortized on a straight-line basis over the terms of the related agreements.

Cost of revenues also includes the expenses associated with the operation of our data centers, including depreciation, labor, energy and bandwidth costs, credit card and other transaction fees related to processing customer transactions as well as content acquisition costs. We have entered into arrangements with certain rights holders under which we distribute or license their video and other content. In a few of these arrangements we display ads on the pages of our web sites from which the content is viewed and share most of the fees these ads generate with the rights holders.

The following tables present our cost of revenues and cost of revenues as a percentage of revenues, and our traffic acquisition costs and traffic acquisition costs as a percentage of advertising revenues for the periods presented (dollars in millions, unaudited):

	March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
Cost of revenues	\$ 904.1	\$ 1,283.1	\$ 1,470.4
Cost of revenues as a percentage of revenues	40.1%	40.0%	40.1%

	March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
Traffic acquisition costs	\$ 722.7	\$ 975.6	\$ 1,125.0
Traffic acquisition costs as a percentage of advertising revenues	32.5%	30.7%	31.0%

Cost of revenues increased \$187.3 million from the three months ended December 31, 2006 to the three months ended March 31, 2007. This increase was primarily the result of additional traffic acquisition costs, the depreciation of additional information technology assets purchased in the current and prior periods and additional data center costs. Over this same period there was an increase in traffic acquisition costs of \$149.4 million primarily as a result of more advertiser fees generated through our AdSense program, and to a lesser extent an increase of \$13.1 million in fees related to distribution arrangements. The increase in cost of revenues is also attributable to an increase in data center costs of \$20.0 million primarily as a result of the depreciation of additional information technology assets and data center buildings as well as additional personnel required to manage the data centers. In addition, there was an increase in costs related to acquiring content on our web sites of \$17.9

million primarily related to our YouTube

Table of Contents

and Google Earth offerings. The increase in traffic acquisition costs as a percentage of advertising revenues was primarily due to our recognition of much higher than average traffic acquisition costs related to several recently launched AdSense arrangements, partially offset by an increase in the proportion of advertising revenues coming from our web sites rather than from our Google Network members' web sites. The traffic acquisition costs associated with revenues generated from ads placed on our web sites is considerably lower than the traffic acquisition costs associated with revenues generated from ads placed on our Google Network members' web sites.

Cost of revenues increased \$566.3 million from the three months ended March 31, 2006 to three months ended March 31, 2007. This increase was primarily the result of additional traffic acquisition costs, the depreciation of additional information technology assets purchased in the current and prior periods, other additional data center costs, content acquisition costs, additional credit card and other transaction fees. Over the same period there was an increase in traffic acquisition costs of \$402.3 million primarily resulting from more advertiser fees generated through our AdSense program, and to a much lesser extent, an increase of \$40.7 million in fees expensed related to distribution arrangements, and an increase in data center costs of \$114.4 million primarily resulting from the depreciation of additional information technology assets as well as additional labor required to manage the data centers. In addition, there was an increase in expenses related to acquiring content on our web sites of \$18.7 million, an increase in credit card and other transaction processing fees of \$9.8 million resulting from more advertiser fees being generated through AdWords and an increase in the amortization of developed technology of \$8.0 million primarily resulting from acquisitions in the prior periods. The decrease in traffic acquisition costs as a percentage of advertising revenues was primarily due to an increase in the proportion of advertising revenues coming from our web sites rather than from our Google Network members' websites, partially offset by our recognition of much higher than average traffic acquisition costs as a percentage of revenues related to several recently launched AdSense arrangements.

We expect cost of revenues to continue to increase in dollars and may increase as a percentage of revenues in 2007 and in future periods compared to 2006, primarily as a result of forecasted increases in traffic acquisition costs, data center costs, credit card and other transaction fees, including transaction processing fees related to Google Checkout, content acquisition and other costs. Traffic acquisition costs as a percentage of advertising revenues may fluctuate in the future based on a number of factors, including:

the relative growth rates of revenues from our web sites and from our Google Network members' web sites.

whether we are able to enter into more AdSense arrangements that provide for lower revenue share obligations or whether increased competition for arrangements with existing and potential Google Network members results in less favorable revenue share arrangements.

whether we are able to continue to improve the monetization of traffic on our web sites and our Google Network members' web sites, particularly with those members to whom we have guaranteed minimum revenue share payments.

whether we share with existing and new partners proportionately more of the aggregate advertising fees that we earn from paid clicks derived from search queries these partners direct to our web sites.

the relative growth rates of expenses associated with distribution arrangements and the related revenues generated.

Research and Development.

The following table presents our research and development expenses, and research and development expenses as a percentage of revenues for the periods presented (dollars in millions, unaudited):

March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
-------------------	---	-------------------

Edgar Filing: Google Inc. - Form 10-Q

Research and development expenses.	\$ 246.6	\$ 386.8	\$ 408.4
Research and development expenses as a percentage of revenues	10.9%	12.1%	11.1%

Research and development expenses consist primarily of compensation and related costs for personnel responsible for the research and development of new products and services, as well as significant improvements to existing products and services. We expense research and development costs as they are incurred.

Research and development expenses increased \$21.6 million from the three months ended December 31, 2006 to the three months ended March 31, 2007. This increase was primarily due to an increase in stock-based compensation expense of \$38.7 million (see discussion below), partially offset by a decrease in labor and facilities related costs of \$19.3 million despite an 11% increase in research and development headcount. The decrease in labor and facilities related costs was primarily due to the disproportionately large increase to our annual bonus in the three months ended December 31, 2006 as a result of our better than expected 2006 financial performance.

Table of Contents

Research and development expenses increased \$161.8 million from the three months ended March 31, 2006 to the three months ended March 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$82.9 million as a result of a 62% increase in research and development headcount and an increase in stock-based compensation expense of \$47.7 million (see discussion below). In addition, there was an increase in depreciation and related expenses of \$14.6 million primarily as a result of an increase in our capital expenditures.

We anticipate that research and development expenses will increase in dollar amount and may increase as a percentage of revenues in 2007 and future periods compared to 2006 because we expect to hire more research and development personnel and build the infrastructure required to support the development of new, and improve existing, products and services. In addition, we expect to recognize incrementally more stock-based compensation as a result of the launch of our employee TSO program in the second quarter of 2007 (see discussion below).

Sales and Marketing.

The following table presents our sales and marketing expenses, and sales and marketing expenses as a percentage of revenues for the periods presented (dollars in millions, unaudited):

	March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
Sales and marketing expenses	\$ 190.9	\$ 255.2	\$ 302.6
Sales and marketing expenses as a percentage of revenues	8.5%	8.0%	8.3%

Sales and marketing expenses consist primarily of compensation and related costs for personnel engaged in customer service and sales and sales support functions, as well as promotional and advertising expenditures.

Sales and marketing expenses increased \$47.4 million from the three months ended December 31, 2006 to the three months ended March 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$18.8 million mostly as a result of a 15% increase in sales and marketing headcount, as well as an increase in stock-based compensation expense of \$12.7 million (see discussion below). In addition, there was an increase in depreciation and related expenses of \$5.8 million and an increase in expenses associated with our annual sales conference held in the first quarter of each year of approximately \$4.3 million.

Sales and marketing expenses increased \$111.7 million from the three months ended March 31, 2006 to the three months ended March 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$80.6 million mostly as a result of an 83% increase in sales and marketing headcount and an increase in depreciation and related expenses of \$16.7 million. In addition, there was an increase in stock-based compensation expense of \$11.3 million (see discussion below).

We anticipate sales and marketing expenses will continue to increase in dollar amount and may increase as a percentage of revenues in 2007 and future periods compared to 2006 as we continue to expand our business on a worldwide basis. A significant portion of these increases relate to our plan to hire additional personnel and increase advertising and promotional expenditures to increase the level of service we provide to our advertisers and Google Network members. We also plan to add a significant number of international sales personnel to support our worldwide expansion. In addition, we expect greater stock based compensation expenses as a result of the launch of our employee TSO program in the second quarter of 2007 (see discussion below).

General and Administrative.

The following table presents our general and administrative expenses, and general and administrative expenses as a percentage of revenues for the periods presented (dollars in millions, unaudited):

	March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
General and administrative expenses	\$ 169.4	\$ 219.7	\$ 261.4

Edgar Filing: Google Inc. - Form 10-Q

General and administrative expenses as a percentage of revenues	7.5%	6.8%	7.2%
---	------	------	------

General and administrative expenses consist primarily of compensation and related costs for personnel and facilities related to our finance, human resources, facilities, information technology and legal organizations, and fees for professional services. Professional services are principally comprised of outside legal, audit, information technology consulting and outsourcing services.

Table of Contents

General and administrative expenses increased \$41.7 million from the three months ended December 31, 2006 to the three months ended March 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$13.4 million primarily as a result of a 22% increase in headcount. In addition, there was an increase in professional services of \$5.1 million as well as an increase in stock-based compensation expense of \$4.5 million (see discussion below).

General and administrative expenses increased \$92.0 million from the three months ended March 31, 2006 to the three months ended March 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$58.9 million primarily as a result of a 99% increase in headcount and an increase in stock-based compensation expense of \$8.1 million (see discussion below). In addition, there was an increase in travel and entertainment expenses of \$7.5 million, an increase in bad debt expense of \$4.1 million and an increase in professional services of \$3.8 million. In addition, in the three months ended March 31, 2006, we recognized \$30.0 million in plaintiffs' attorneys' fees related to the settlement of the Lane's Gift class action lawsuit.

As we expand our business and incur additional expenses, we believe general and administrative expenses will increase in dollar amount and may increase as a percentage of revenues in 2007 and future periods compared to 2006. In addition, we expect greater stock based compensation expenses as a result of the launch of our employee TSO program in the second quarter of 2007 (see discussion below).

Stock-Based Compensation.

The following table presents our stock-based compensation, and stock-based compensation as a percentage of revenues for the periods presented (dollars in millions, unaudited):

	March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
Stock-based compensation.	\$ 114.7	\$ 134.4	\$ 183.9
Stock-based compensation as a percentage of revenues	5.1%	4.2%	5.0%

Stock-based compensation increased \$49.5 million from the three months ended December 31, 2006 to the three months ended March 31, 2007. This increase was primarily due to stock-based compensation recognized in the three months ended March 31, 2007 related to unvested stock awards issued as a result of our acquisition of YouTube on November 13, 2006, compared to that recognized for approximately one-half of a quarter in the three months ended December 31, 2006.

Stock-based compensation increased \$69.2 million from the three months ended March 31, 2006 to the three months ended March 31, 2007. The increase was primarily due to additional stock-based compensation associated with unvested stock awards issued as a result of our acquisition of YouTube in the fourth quarter of 2006.

In April 2007, we launched our employee transferable stock option (TSO) program. Under the TSO program, certain employees are able to sell vested options granted under our 2004 Stock Plan to selected financial institutions in an online auction. All employees may sell under the program other than our executive management group and those that reside in countries where, due to local legal and/or tax implications, it would not be beneficial to employees or the TSO program would be impractical. All eligible outstanding options were modified in the second quarter to allow selling under the TSO program and, as a result, we will incur a modification charge of approximately \$70 million in the second quarter of 2007 related to vested options as of the end of that quarter and a charge of approximately \$160 million over their remaining vesting periods of up to approximately four years related to unvested options. The modification charge is equal to the difference between the values of those modified stock options on the date of modification and their values immediately prior to modification in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment*. Further, to the extent the forfeiture rate is different than we have anticipated, the modification charge related to these awards will be different from our expectations. The fair value of each option granted under the TSO program will be greater than it would have been otherwise because of a longer expected life, resulting in more stock-based compensation per option. Before the aforementioned incremental charges related to the TSO program, we expect stock-based compensation to be approximately \$639.0 million in 2007 and \$921.8 million thereafter. These amounts do not include stock-based compensation related to stock awards that have been and may be granted to employees and directors subsequent to March 31, 2007 and stock awards that have been or may be granted to non-employees. In addition, to the extent forfeiture rates are different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

Table of Contents**Interest Income and Other, Net**

Interest income and other of \$130.7 million in the three months ended March 31, 2007 was primarily comprised of \$130.1 million of interest income earned on our cash, cash equivalents and marketable securities balances. In addition, we recognized \$8.1 million of realized gains on sales of marketable securities. These income sources were partially offset by \$5.7 million of net foreign exchange losses in the quarter.

Interest income and other of \$67.9 million in the three months ended March 31, 2006 was primarily comprised of \$78.9 million of interest income earned on our cash, cash equivalents and marketable securities balances. This increase was partially offset by \$7.6 million of realized losses on sales of marketable securities, and \$4.5 million of net foreign exchange losses as a result of (i) the forward contracts that we entered into to purchase U.S. dollars with foreign currencies to offset the foreign exchange risk on certain intercompany assets and (ii) the net monetary assets denominated in currencies other than the local currencies.

Provision for Income Taxes

The following table presents our provision for income taxes, and effective tax rate for the periods presented (dollars in millions, unaudited):

	March 31, 2006	Three Months Ended December 31, 2006 (unaudited)	March 31, 2007
Provision for income taxes	\$ 218.3	\$ 154.0	\$ 349.8
Effective tax rate	26.9%	13.0%	25.9%

Our provision for income taxes and effective tax rate increased from the three months ended December 31, 2006 to the three months ended March 31, 2007, primarily as a result of certain income tax benefits realized in the three months ended December 31, 2006 related to the reduction to certain of our income tax contingency reserves (see discussion below). In addition, the dollar increase in our provision for income taxes was also due to increases in federal and state income taxes, driven by higher taxable income period over period.

In December 2006, we entered into an Advanced Pricing Agreement (APA) with the Internal Revenue Service in connection with certain intercompany transfer pricing arrangements beginning in 2003. As a result of the APA, we reduced certain of our income tax contingency reserves and recognized an income tax benefit of \$90.3 million in the fourth quarter of 2006. Also, during the three months ended December 31, 2006, the 2006 Research and Development Tax Credit was signed into federal law, which resulted in a \$77.9 million benefit to our provision for income taxes, of which \$42.8 million pertained to the first three quarters of 2006. Without the aforementioned discrete benefits, our effective tax rate would have been higher than 13.0% in the three months ended December 31, 2006.

Our provision for income taxes increased from the three months ended March 31, 2006 to the three months ended March 31, 2007, primarily as a result of increases in federal and state income taxes, driven by higher taxable income period over period.

Our effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected to the extent earnings are lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets or liabilities, or by changes in tax laws, regulations, accounting principles, or interpretations thereof. 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.

Liquidity and Capital Resources

In summary, our cash flows were (in millions, unaudited):

**Three Months Ended
March 31,
2006 2007
(unaudited)**

Edgar Filing: Google Inc. - Form 10-Q

Net cash provided by operating activities	\$ 824.8	\$ 1,219.6
Net cash used in investing activities	(1,888.6)	(777.1)
Net cash provided by financing activities	119.9	88.5

Table of Contents

As a result of the completion of our initial public offering in August 2004 and our follow-on public stock offerings in September 2005 and April 2006, we raised \$1.2 billion, \$4.3 billion and \$2.1 billion of net proceeds. At March 31, 2007, we had \$11.9 billion of cash, cash equivalents and marketable securities. Cash equivalents and marketable securities are comprised of highly liquid debt instruments of the U.S. government and its agencies, municipalities in the U.S. as well as time deposits. Note 3 of Notes to Condensed Consolidated Financial Statements included as part of this report describes further the composition of our cash, cash equivalents and marketable securities.

Our principal sources of liquidity are our cash, cash equivalents and marketable securities, as well as the cash flow that we generate from our operations. At December 31, 2006 and March 31, 2007, we had unused letters of credit for approximately \$17.7 million and \$12.8 million. We believe that our existing cash, cash equivalents, marketable securities and cash generated from operations will be sufficient to satisfy our currently anticipated cash requirements through at least the next 12 months. Our liquidity could be negatively affected by a decrease in demand for our products and services. In addition, we may make acquisitions or license products and technologies complementary to our business and may need to raise additional capital through future debt or equity financing to provide for greater flexibility to fund any such acquisitions and licensing activities. Additional financing may not be available at all or on terms favorable to us.

Cash provided by operating activities consisted of net income adjusted for certain non-cash items including depreciation, amortization, in-process research and development, stock-based compensation, and the effect of changes in working capital and other activities. Cash provided by operating activities in the three months ended March 31, 2007 was \$1,219.6 million and consisted of net income of \$1,002.2 million, adjustments for non-cash items of \$308.4 million and cash used in working capital and other activities of \$91.0 million. Adjustments for non-cash items primarily consisted of \$170.3 million of depreciation and amortization expense on property and equipment and \$183.9 million of stock-based compensation, partially offset by \$74.1 million of excess tax benefits from stock-based award activity. In addition, working capital activities primarily consisted of an increase of \$185.5 million in prepaid revenue share, expenses and other assets, an increase of \$153.6 million in accounts receivable due to the growth in fees billed to our advertisers, a decrease of \$169.1 million in accrued expenses and other liabilities and accounts payable primarily as a result of employee bonuses for the year ended December 31, 2006 paid in the first quarter of 2007, partially offset by a net increase in income taxes payable and deferred income taxes of \$337.7 million, which includes the same \$74.1 million of excess tax benefits from stock-based awards included under adjustments for non-cash items. The increase in income taxes payable and deferred income taxes was primarily a result of additional tax obligations accrued, as well as less estimated income taxes paid, in the first quarter of 2007 compared to the fourth quarter of 2006.

Cash provided by operating activities in the three months ended March 31, 2006 was \$824.8 million and consisted of net income of \$592.3 million, adjustments for non-cash items of \$229.8 million and cash provided by working capital and other activities of \$2.7 million. Adjustments for non-cash items primarily consisted of \$95.9 million of depreciation and amortization expense on property and equipment and \$114.7 million of stock-based compensation, partially offset by \$77.3 million of excess tax benefits from stock-based award activity. In addition, working capital activities primarily consisted of an increase of \$155.2 million in accounts receivable due to the growth in fees billed to our advertisers, offset by a net increase in income taxes payable and deferred income taxes of \$139.2 million which includes the same \$77.3 million of excess tax benefits from stock-based award included under adjustments for non-cash items and an increase of \$51.2 million in accrued revenue share due to the growth in our AdSense programs and the timing of payments made to our Google Network members.

As we expand our business internationally, we have offered payment terms to certain advertisers that are standard in their locales, but longer than terms we would generally offer to our domestic advertisers. This may increase our working capital requirements and may have a negative effect on cash flow provided by our operating activities. In addition, since we have become a public company our cash-based compensation per employee has increased and will likely continue to increase in order to retain and attract employees.

Cash used in investing activities in the three months ended March 31, 2007 of \$777.1 million was attributable to net purchases of marketable securities of \$145.8 million, capital expenditures of \$596.9 million and cash consideration used in acquisitions and other investments of \$34.4 million. Cash used in investing activities in the three months ended March 31, 2006 of \$1,888.6 million was attributable to net purchases of marketable securities of \$1,355.7 million, capital expenditures of \$344.9 million and cash consideration used in acquisitions and other investments of \$188.0 million, a majority of which was related to the acquisition of dMarc Broadcasting, Inc.

In addition, we expect to spend a significant amount of cash on acquisitions and other investments from time to time. Through these acquisitions and investments, we acquire engineering teams, technologies and other assets. As noted under **Recent Developments** above, in April 2007, we entered into an Agreement and Plan of Merger with DoubleClick to acquire all of the outstanding interests of DoubleClick, a privately held company, for \$3.1 billion in cash subject to certain adjustments. Also in connection with the acquisition of dMarc, we are obligated to make additional cash payments of up to \$1,136.0 million if certain performance targets are met through December 31, 2008. Since these contingent payments are based on the achievement of performance targets, actual payments may be substantially lower.

Table of Contents

Also, as part of our philanthropic program, we expect to make equity and other investments in for-profit enterprises that aim to alleviate poverty, improve the environment or achieve other socially or economically progressive objectives. We expect these investments to be made primarily in cash and to be approximately \$175 million over the three years ended December 31, 2008.

Cash provided by financing activities in the three months ended March 31, 2007 of \$88.5 million was due primarily to excess tax benefits of \$74.1 million from stock-based award activity during the period which represents a portion of the \$107.1 million reduction to income taxes payable that we recorded in the first quarter of 2007 related to the total direct tax benefit realized from the exercise, sale or vesting of these awards. In addition, we received net proceeds from the issuance of common stock pursuant to stock-based award activity of \$14.4 million. Cash provided by financing activities in the three months ended March 31, 2006 of \$119.9 million was due primarily to excess tax benefits of \$77.3 million from stock-based award activity during the period and net proceeds from the issuance of common stock pursuant to stock option exercises of \$42.6 million.

Contractual Obligations

We are obligated under certain agreements to make non-cancelable guaranteed minimum revenue share payments to Google Network members based on their achieving defined performance terms, such as number of search queries or advertisements displayed. At March 31, 2007, our aggregate outstanding non-cancelable guaranteed minimum revenue share commitments totaled \$1.27 billion through 2011 compared to \$1.17 billion at December 31, 2006.

In addition, upon adoption of FIN 48 on January 1, 2007, we decreased current taxes payable by \$219.4 million and increased long-term taxes payable by the same amount as FIN 48 specifies that tax positions for which the timing of the ultimate resolution is uncertain should be recognized as long-term liabilities. We also recognized additional long-term taxes payable of \$48.5 million in the three months ended March 31, 2007. At this time, we are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

Critical Accounting Policies and Estimates

We prepare our Condensed Consolidated Financial Statements in accordance with accounting principles generally accepted in the U.S. In doing so, we have to make estimates and assumptions that affect our reported amounts of assets, liabilities, revenues and expenses, as well as related disclosure of contingent assets and liabilities. In many cases, we could reasonably have used different accounting policies and estimates. In some cases changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis. We refer to accounting estimates of this type as critical accounting policies and estimates, which we discuss further below. We have reviewed our critical accounting policies and estimates with the audit committee of our board of directors.

Income Taxes

We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in evaluating our tax positions and determining our provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes and interest will be due. These reserves are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions are likely to be challenged and may not be sustained on review by tax authorities. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest.

Our effective tax rates have differed from the statutory rate primarily due to the tax impact of foreign operations, research and experimentation tax credits, state taxes, and certain benefits realized related to stock option activity. The effective tax rate was 13.0% and 25.9% for the three months ended December 31, 2006 and March 31, 2007. Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets or liabilities, or by changes in tax laws, regulations, accounting principles, or interpretations thereof. 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.

Stock Based Compensation

We account for stock-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, *Shared-Based Payment*. Under the provisions of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the award's fair value as calculated by the Black-Scholes-Merton (BSM) option-pricing model and is recognized as expense over

Table of Contents

the requisite service period. The BSM model requires various highly judgmental assumptions including volatility, forfeiture rates, and expected option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

Effect of Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for us beginning January 1, 2008. We are currently evaluating the impact of the adoption of SFAS No. 157 on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities- including an Amendment of FASB Statement No. 115*, which allows an entity to choose to measure certain financial instruments and liabilities at fair value. Subsequent measurements for the financial instruments and liabilities an entity elects to fair value will be recognized in earnings. SFAS No. 159 also establishes additional disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted provided that the entity also adopts SFAS No. 157. We are currently evaluating whether to adopt SFAS No. 159.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to financial market risks, including changes in currency exchange rates and interest rates.

Foreign Exchange Risk

Our exposure to foreign currency transaction gains and losses is the result of certain net receivables due from our foreign subsidiaries and customers being denominated in currencies other than the U.S. dollar, primarily the British pound, the euro, the Canadian dollar and the Japanese yen. Our foreign subsidiaries conduct their businesses in local currency. Effective January 2004, our board of directors approved a foreign exchange hedging program designed to minimize the future potential impact due to changes in foreign currency exchange rates. The program allows for the hedging of transaction exposures. The types of derivatives that can be used under the policy are forward contracts, options and foreign exchange swaps. The vehicle we use is forward contracts. We also generate revenue in certain countries in Asia where there are limited forward currency exchange markets, thus making these exposures difficult to hedge. We have entered into forward foreign exchange contracts to offset the foreign exchange risk on certain intercompany assets, as well as cash denominated in currencies other than the local currency of the subsidiary. The notional principal of forward foreign exchange contracts to purchase U.S. dollars with euros was \$1.1 billion at March 31, 2007. The notional principal of forward foreign exchange contracts to purchase euros with British pounds, Japanese yen and Australian dollars was 216.4 million (or approximately \$288.3 million) at March 31, 2007. The notional principal of forward foreign exchange contracts to sell euros for Taiwan dollars was 18.2 million (or approximately \$24.3 million) at March 31, 2007. There were no other forward exchange contracts outstanding at March 31, 2007.

Our exposure to foreign currency translation gains and losses arises from the translation of net assets of our subsidiaries to U.S. dollars during consolidation. We recognized translation gains of \$12.7 million in the three months ended March 31, 2007 primarily as a result of generally strengthening foreign currencies against the U.S. dollar.

We considered the historical trends in currency exchange rates and determined that it was reasonably possible that adverse changes in exchange rates of 10% for all currencies could be experienced in the near term. These changes would have resulted in an adverse impact on income before income taxes of approximately \$11.6 million and \$6.6 million at December 31, 2006 and March 31, 2007. The adverse impact at March 31, 2007 and December 31, 2006 is after consideration of the offsetting effect of approximately \$113.6 million and \$135.2 million from forward exchange contracts in place for the months of December 2006 and March 2007. These reasonably possible adverse changes in exchange rates of 10% were applied to total monetary assets denominated in currencies other than the local currencies at the balance sheet dates to compute the adverse impact these changes would have had on our income before taxes in the near term.

Interest Rate Risk

We invest in a variety of securities, consisting primarily of investments in interest-bearing demand deposit accounts with financial institutions, tax-exempt money market funds and highly liquid debt securities of corporations and municipalities. By policy, we limit the amount of credit exposure to any one issuer.

Table of Contents

Investments in both fixed rate and floating rate interest earning products carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. Due in part to these factors, our income from investments may decrease in the future.

We considered the historical volatility of short term interest rates and determined that it was reasonably possible that an adverse change of 100 basis points could be experienced in the near term. A hypothetical 1.00% (100 basis-point) increase in interest rates would have resulted in a decrease in the fair values of our marketable securities of approximately \$98.8 million and \$88.5 million at December 31, 2006 and March 31, 2007.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures.

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 as of the end of the period covered by this Quarterly Report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission 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 timely decisions regarding required disclosure.

(b) Changes in internal control over financial reporting.

We regularly review our system of internal control over financial reporting to ensure we maintain an effective internal control environment. As we grow geographically and with new product offerings, we continue to create new processes and controls as well as improve our existing environment to increase efficiencies. Improvements may include such activities as implementing new, more efficient systems, consolidating activities, and migrating processes.

There were no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

From time to time, we are involved in a variety of claims, suits, investigations and proceedings arising from the ordinary course of our business, including actions with respect to intellectual property claims, breach of contract claims, labor and employment claims, tax and other matters. Although claims, suits, investigations and proceedings are inherently uncertain and their results cannot be predicted with certainty, we believe that the resolution of our current pending matters will not have a material adverse effect on our business, consolidated financial position, results of operations or cash flow. Regardless of the outcome, litigation can have an adverse impact on us because of defense costs, diversion of management resources and other factors. In addition, it is possible that an unfavorable resolution of one or more such proceedings could in the future materially affect our financial position, results of operations or cash flows in a particular period. See the risk factors *We are, and may in the future be, subject to intellectual property rights claims, which are costly to defend, could require us to pay damages and could limit our ability to use certain technologies in the future* and *Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products, services and brand* in the Risks Related to Our Business and Industry section of Item 1A of this Quarterly Report on Form 10-Q.

ITEM 1A. RISK FACTORS**Risks Related to Our Business and Industry**

We face significant competition from Microsoft and Yahoo.

We face formidable competition in every aspect of our business, and particularly from other companies that seek to connect people with information on the web and provide them with relevant advertising. Currently, we consider our primary competitors to be Microsoft Corporation and Yahoo! Inc. Microsoft has developed features that make web search a more integrated part of its Windows operating system and other desktop software products. We expect that Microsoft will increasingly use its financial and engineering resources to compete with us and Microsoft has more employees and cash resources than we do. Also, both Microsoft and Yahoo have longer operating histories and more established relationships with customers and end users. They can use their experience and resources against us in a variety of competitive ways, including by making acquisitions, investing more aggressively in research and development and competing more aggressively for advertisers and web sites. Microsoft and Yahoo also may have a greater ability to attract and retain users than we do because they operate internet portals with a broad range of content products and services. If Microsoft or Yahoo are successful in providing similar or better web search results, more relevant advertisements or in leveraging their platforms or products to make their web search or advertiser services easier to access, we could experience a significant decline in user traffic or in the size of the Google Network. Any such decline could negatively affect our revenues. [Comment on MSFT/YHOO merger rumors if they become more certain prior to the filing]

We face competition from other internet companies, including web search providers, internet access providers, internet advertising companies and destination web sites that may also bundle their services with internet access.

In addition to Microsoft and Yahoo, we face competition from other web search providers, including start-ups as well as developed companies that are enhancing or developing search technologies. We compete with internet advertising companies, particularly in the areas of pay-for-performance and keyword-targeted internet advertising. Also, we may compete with companies that sell products and services online because these companies, like us, are trying to attract users to their web sites to search for information about products and services. We also provide a number of online products and services, including Google Checkout, YouTube and our communications tools such as Google Docs and Spreadsheets, that compete directly with new and established companies that offer communication, information and entertainment services integrated into their products or media properties.

We also compete with destination web sites that seek to increase their search-related traffic. These destination web sites may include those operated by internet access providers, such as cable and DSL service providers. Because our users need to access our services through internet access providers, they have direct relationships with these providers. If an access provider or a computer or computing device manufacturer offers online services that compete with ours, the user may find it more convenient to use the services of the access provider or manufacturer. In addition, the access provider or manufacturer may make it hard to access our services by not listing them in the access provider's or manufacturer's own menu of offerings, or may charge users to access our web sites or the web sites of our Google Network members. Also, because the access provider gathers information from the user in connection with the establishment of a billing relationship, the access provider may be more effective than we are in tailoring services and advertisements to the specific tastes of the user.

Edgar Filing: Google Inc. - Form 10-Q

There has been a trend toward industry consolidation among our competitors, and so smaller competitors today may become larger competitors in the future. If our competitors are more successful than we are at generating traffic, our revenues may decline.

Table of Contents

We face competition from traditional media companies, and we may not be included in the advertising budgets of large advertisers, which could harm our operating results.

In addition to internet companies, we face competition from companies that offer traditional media advertising opportunities. Most large advertisers have set advertising budgets, a small portion of which is allocated to internet advertising. We expect that large advertisers will continue to focus most of their advertising efforts on traditional media. If we fail to convince these companies to spend a portion of their advertising budgets with us, or if our existing advertisers reduce the amount they spend on our programs, our operating results would be harmed.

We expect our revenue growth rate to decline and anticipate downward pressure on our operating margin in the future.

We expect that our revenue growth rate will decline over time and anticipate that there will be downward pressure on our operating margin. We believe our revenue growth rate will generally decline as a result of increasing competition and the inevitable decline in growth rates as our revenues increase to higher levels. We believe our operating margin will experience downward pressure as a result of increasing competition and increased expenditures for many aspects of our business. Our operating margin will also experience downward pressure if a greater percentage of our revenues comes from ads placed on our Google Network members' sites compared to revenues generated through ads placed on our own sites. The margin on revenue we generate from our Google Network members is significantly less than the margin on revenue we generate from advertising on our web sites. Additionally, the margin we earn on revenue generated from our Google Network could decrease in the future if we pay an even larger percentage of advertising fees to our Google Network members.

Our operating results may fluctuate, which makes our results difficult to predict and could cause our results to fall short of expectations.

Our operating results may fluctuate as a result of a number of factors, many outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful, and you should not rely on our past results as an indication of our future performance. Our quarterly, year-to-date and annual expenses as a percentage of our revenues may differ significantly from our historical or projected rates. Our operating results in future quarters may fall below expectations. Any of these events could cause our stock price to fall. Each of the risk factors listed in this Item 1A, Risk Factors, and the following factors may affect our operating results:

Our ability to continue to attract users to our web sites.

Our ability to monetize (or generate revenue from) traffic on our web sites and our Google Network members' web sites.

Our ability to attract advertisers to our AdWords program.

Our ability to attract web sites to our AdSense program.

The mix in our revenues between those generated on our web sites and those generated through our Google Network.

The amount and timing of operating costs and capital expenditures related to the maintenance and expansion of our businesses, operations and infrastructure.

Our focus on long-term goals over short-term results.

The results of our investments in risky projects.

Edgar Filing: Google Inc. - Form 10-Q

Our ability to keep our web sites operational at a reasonable cost and without service interruptions.

Our ability to achieve revenue goals for partners to whom we guarantee minimum payments or pay distribution fees.

Our ability to generate revenue from services in which we have invested considerable time and resources, such as YouTube, Gmail and orkut.

Because our business is changing and evolving, our historical operating results may not be useful to you in predicting our future operating results. In addition, advertising spending has historically been cyclical in nature, reflecting overall economic conditions as well as budgeting and buying patterns. For example, in 1999, advertisers spent heavily on internet advertising. This was followed by a lengthy downturn in ad spending on the web. Also, user traffic tends to be seasonal. Our rapid growth has masked the cyclical and seasonality of our business. As our growth rate has slowed, the cyclical and seasonality in our business has become more pronounced and will cause our operating results to fluctuate in the future.

If we do not continue to innovate and provide products and services that are useful to users, we may not remain competitive, and our revenues and operating results could suffer.

Our success depends on providing products and services that make using the internet a more useful and enjoyable experience for our users. Our competitors are constantly developing innovations in web search, online advertising and web based products and services. As a result, we must continue to invest significant resources in research and development in order to enhance our web search technology and our existing products and services and introduce new products and services that people can easily and effectively use. If we are unable to provide quality products and services, then our users may become dissatisfied and move to a competitors products and services. Our operating results would also suffer if our innovations are not responsive to the needs of our users, advertisers and

Table of Contents

Google Network members, are not appropriately timed with market opportunities or are not effectively brought to market. As search technology continues to develop, our competitors may be able to offer search results that are, or that are seen to be, substantially similar to or better than ours. This may force us to compete in different ways and expend significant resources in order to remain competitive.

We generate our revenue almost entirely from advertising, and the reduction in spending by or loss of advertisers could seriously harm our business.

We generated approximately 99% of our revenues in 2006 and the first three months of 2007 from our advertisers. Our advertisers can generally terminate their contracts with us at any time. Advertisers will not continue to do business with us if their investment in advertising with us does not generate sales leads, and ultimately customers, or if we do not deliver their advertisements in an appropriate and effective manner. If we are unable to remain competitive and provide value to our advertisers, they may stop placing ads with us, which would negatively harm our revenues and business.

We rely on our Google Network members for a significant portion of our revenues, and we benefit from our association with them. The loss of these members could adversely affect our business.

We provide advertising, web search and other services to members of our Google Network, which accounted for 39% of our revenues in 2006 and 37% of our revenues in the three months ended March 31, 2007. Some of the participants in this network may compete with us in one or more areas. Therefore, they may decide in the future to terminate their agreements with us. If our Google Network members decide to use a competitor's or their own web search or advertising services, our revenues would decline. Our agreements with a few of the largest Google Network members account for a significant portion of revenues derived from our AdSense program. In addition, advertising and other fees generated from one Google Network member, AOL, primarily through our AdSense program, accounted for approximately 7% and 6% of our revenues in 2006 and in the three months ended March 31, 2007, respectively. In the first half of 2006, we entered into an arrangement with AOL and Time Warner under which we acquired a five percent indirect equity interest in AOL in exchange for \$1 billion in cash and expanded our strategic alliance with AOL. If our relationship with AOL were terminated or renegotiated on terms less favorable to us, our business could be adversely affected.

Also, certain of our key network members operate high-profile web sites, and we derive tangible and intangible benefits from this affiliation. If one or more of these key relationships is terminated or not renewed, and is not replaced with a comparable relationship, our business would be adversely affected.

Our business and operations are experiencing rapid growth. If we fail to effectively manage our growth, our business and operating results could be harmed.

We have experienced, and continue to experience, rapid growth in our headcount and operations, which has placed, and will continue to place, significant demands on our management, operational and financial infrastructure. If we do not effectively manage our growth, the quality of our products and services could suffer, which could negatively affect our brand and operating results. Our expansion and growth in international markets heightens these risks as a result of the particular challenges of supporting a rapidly growing business in an environment of multiple languages, cultures, customs, legal systems, alternative dispute systems, regulatory systems and commercial infrastructures. To effectively manage this growth, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. These systems enhancements and improvements will require significant capital expenditures and management resources. Failure to implement these improvements could hurt our ability to manage our growth and our financial position.

Our business depends on a strong brand, and failing to maintain and enhance our brand would hurt our ability to expand our base of users, advertisers and Google Network members.

The brand identity that we have developed has significantly contributed to the success of our business. Maintaining and enhancing the Google brand is critical to expanding our base of users, advertisers, Google Network members, and other partners. We believe that the importance of brand recognition will increase due to the relatively low barriers to entry in the internet market. If we fail to maintain and enhance the Google brand, or if we incur excessive expenses in this effort, our business, operating results and financial condition will be materially and adversely affected. Maintaining and enhancing our brand will depend largely on our ability to be a technology leader and to continue to provide high-quality products and services, which we may not do successfully.

Acquisitions could result in operating difficulties, dilution and other harmful consequences.

Edgar Filing: Google Inc. - Form 10-Q

We do not have a great deal of experience acquiring companies and the companies we have acquired have typically been small. We frequently evaluate and enter into discussions regarding a wide array of potential strategic transactions. Any of these transactions could be material to our financial condition and results of operations. In addition, the process of integrating an acquired company, business or technology may create unforeseen operating difficulties and expenditures and is risky. The areas where we may face risks include:

Implementation or remediation of controls, procedures and policies at the acquired company.

Table of Contents

Diversion of management time and focus from operating our business to acquisition integration challenges.

Cultural challenges associated with integrating employees from the acquired company into our organization.

Retention of employees from the businesses we acquire.

Integration of each company's accounting, management information, human resource and other administrative systems. Foreign acquisitions involve unique risks in addition to those mentioned above, including those related to integration of operations across different cultures and languages, currency risks and the particular economic, political and regulatory risks associated with specific countries.

Future acquisitions or dispositions could also result in dilutive issuances of our equity securities, the incurrence of debt, contingent liabilities or amortization expenses, or write-offs of goodwill, any of which could harm our financial condition. Future acquisitions may require us to obtain additional equity or debt financing, which may not be available on favorable terms or at all. Also, the anticipated benefit of many of our acquisitions may not materialize. For example, we have yet to realize significant revenue benefits from our acquisitions of dMarc Broadcasting (Audio Ads) or YouTube.

Our corporate culture has contributed to our success, and if we cannot maintain this culture as we grow, we could lose the innovation, creativity and teamwork fostered by our culture, and our business may be harmed.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity and teamwork. As our organization grows, and we are required to implement more complex organizational management structures, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. This could negatively impact our future success.

Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products, services and brand.

Our patents, trademarks, trade secrets, copyrights and other intellectual property rights are important assets for us. Various events outside of our control pose a threat to our intellectual property rights as well as to our products and services. For example, effective intellectual property protection may not be available in every country in which our products and services are distributed or made available through the internet. Also, the efforts we have taken to protect our proprietary rights may not be sufficient or effective. Any significant impairment of our intellectual property rights could harm our business or our ability to compete. Also, protecting our intellectual property rights is costly and time consuming. Any increase in the unauthorized use of our intellectual property could make it more expensive to do business and harm our operating results.

Although we seek to obtain patent protection for our innovations, it is possible we may not be able to protect some of these innovations. In addition, given the costs of obtaining patent protection, we may choose not to protect certain innovations that later turn out to be important. Furthermore, there is always the possibility, despite our efforts, that the scope of the protection gained will be insufficient or that an issued patent may be deemed invalid or unenforceable.

We also face risks associated with our trademarks. For example, there is a risk that the word "Google" could become so commonly used that it becomes synonymous with the word "search." If this happens, we could lose protection for this trademark, which could result in other people using the word "Google" to refer to their own products, thus diminishing our brand.

We also seek to maintain certain intellectual property as trade secrets. The secrecy could be compromised by outside parties, or intentionally or accidentally by our employees, which would cause us to lose the competitive advantage resulting from these trade secrets.

We are, and may in the future be, subject to intellectual property rights claims, which are costly to defend, could require us to pay damages and could limit our ability to use certain technologies in the future.

Companies in the internet, technology and media industries own large numbers of patents, copyrights, trademarks and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. As we grow, the number of intellectual property rights claims against us will likely increase. Our products, services and technologies may not be able to withstand any third-party claims and regardless of the merits of the claim, intellectual property claims are often time-consuming and expensive to litigate or settle. In addition, to the extent claims against us are successful, we may have to pay substantial monetary damages or discontinue any of our

Edgar Filing: Google Inc. - Form 10-Q

services or practices that are found to be in violation of another party's rights. We also may have to seek a license to continue such practices, which may significantly increase our operating expenses. In addition, many of our agreements with members of our Google Network and other partners require us to indemnify these members for certain third-party intellectual property infringement claims, which would increase our costs as a result of defending such claims and may require that we pay damages if there were an adverse ruling in any such claims.

Table of Contents

Companies have filed trademark infringement and related claims against us over the display of ads in response to user queries that include trademark terms. The outcomes of these lawsuits have differed from jurisdiction to jurisdiction. Courts in France have held us liable for allowing advertisers to select certain trademarked terms as keywords. We are appealing those decisions. We were also subject to two lawsuits in Germany on similar matters where the courts held that we are not liable for the actions of our advertisers prior to notification of trademark rights. We are litigating or have recently litigated similar issues in other cases in the U.S., France, Germany, Israel, Italy and Austria.

We have also had copyright claims filed against us alleging that features of certain of our products and services, including Google Web Search, Google News, Google Video, Google Image Search, Google Book Search and YouTube, infringe their rights. Adverse results in these lawsuits may include awards of substantial monetary damages, costly royalty or licensing agreements or orders preventing us from offering certain functionalities, and may also result in a change in our business practices, which could result in a loss of revenue for us or otherwise harm our business. In addition, any time one of our products or services links to or hosts material in which others allegedly own copyrights, we face the risk of being sued for copyright infringement or related claims. Because these products and services comprise the majority of our products and services, the risk of harm from such lawsuits could be substantial.

Privacy concerns relating to our technology could damage our reputation and deter current and potential users from using our products and services.

From time to time, concerns have been expressed about whether our products and services compromise the privacy of users and others. Concerns about our practices with regard to the collection, use, disclosure or security of personal information or other privacy-related matters, even if unfounded, could damage our reputation and operating results. While we strive to comply with all applicable data protection laws and regulations, as well as our own posted privacy policies, any failure or perceived failure to comply may result in proceedings or actions against us by government entities or others, which could potentially have an adverse affect on our business.

In addition, as nearly all of our products and services are web based, the amount of data we store for our users on our servers (including personal information) has been increasing. Any systems failure or compromise of our security that results in the release of our users' data could seriously limit the adoption of our products and services as well as harm our reputation and brand and, therefore, our business. We may also need to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand the number of web based products and services we offer as well as increase the number of countries where we operate.

A large number of legislative proposals pending before the United States Congress, various state legislative bodies and foreign governments concern data protection. In addition, the interpretation and application of data protection laws in Europe and elsewhere are still uncertain and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could have a material effect on our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

Our business is subject to a variety of U.S. and foreign laws that could subject us to claims or other remedies based on the nature and content of the information searched or displayed by our products and services.

The laws relating to the liability of providers of online services are currently unsettled both within the U.S. and abroad. Claims have been threatened and filed under both U.S. and foreign law for defamation, libel, invasion of privacy and other data protection claims, tort, unlawful activity, copyright or trademark infringement, or other theories based on the nature and content of the materials searched and the ads posted by our users, our products and services, or content generated by our users.

In addition, compliance with these laws is complex and may impose significant additional costs on us. For example, the Digital Millennium Copyright Act has provisions that limit, but do not necessarily eliminate, our liability for listing or linking to third-party web sites that include materials that infringe copyrights or other rights, so long as we comply with the statutory requirements of this act. The Children's Online Protection Act and the Children's Online Privacy Protection Act restrict the distribution of materials considered harmful to children and impose additional restrictions on the ability of online services to collect information from minors. In addition, the Protection of Children from Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances. Any failure on our part to comply with these regulations may subject us to additional liabilities.

Our international operations are subject to increased risks which could harm our business, operating results and financial condition.

International revenues accounted for approximately 47% of our total revenues in the first three months of 2007 and more than half of our user traffic came from outside the U.S. during this period. We have limited experience with operations outside the U.S. and our ability to manage our

Edgar Filing: Google Inc. - Form 10-Q

business and conduct our operations internationally requires considerable management attention and resources and is subject to a number of risks, including the following:

Challenges caused by distance, language and cultural differences and by doing business with foreign agencies and governments.

Table of Contents

Difficulties in developing products and services in different languages and for different cultures.

Longer payment cycles in some countries.

Credit risk and higher levels of payment fraud.

Currency exchange rate fluctuations.

Foreign exchange controls that might prevent us from repatriating cash earned in countries outside the U.S.

Import and export requirements that may prevent us from shipping products or providing services to a particular market and may increase our operating costs.

Political and economic instability.

Potentially adverse tax consequences.

Higher costs associated with doing business internationally.

In addition, compliance with complex foreign and U.S. laws and regulations that apply to our international operations increases our cost of doing business in international jurisdictions and could expose us to fines and penalties. These laws and regulations include import and export requirements, U.S. laws such as the Foreign Corrupt Practices Act, and local laws prohibiting corrupt payments to governmental officials. Although we have implemented policies and procedures designed to ensure compliance with these laws, there can be no assurance that our employees, contractors or agents will not violate our policies. Any such violations could include prohibitions on our ability to offer our products and services to one or more countries, and could also materially damage our reputation, our brand, our international expansion efforts, our business and our operating results.

We compete internationally with local information providers and with U.S. competitors who are currently more successful than we are in various markets, and if we fail to compete effectively in international markets, our business will be harmed.

We face different market characteristics and competition outside the U.S. In certain markets, other web search, advertising services and internet companies have greater brand recognition, more users and more search traffic than we have. Even in countries where we have a significant user following, we may not be as successful in generating advertising revenue due to slower market development, our inability to provide attractive local advertising services or other factors. In order to compete, we need to improve our brand recognition and our selling efforts internationally and build stronger relationships with advertisers. We also need to better understand our international users and their preferences. If we fail to do so, our global expansion efforts may be more costly and less profitable than we expect.

Our business may be adversely affected by malicious applications that interfere with, or exploit security flaws in, our products and services.

Our business may be adversely affected by malicious applications that make changes to our users' computers and interfere with the Google experience. These applications have in the past attempted, and may in the future attempt, to change our users' internet experience, including hijacking queries to Google.com, altering or replacing Google search results, or otherwise interfering with our ability to connect with our users. The interference often occurs without disclosure to or consent from users, resulting in a negative experience that users may associate with Google. These applications may be difficult or impossible to uninstall or disable, may reinstall themselves and may circumvent other applications' efforts to block or remove them. In addition, we offer a number of products and services that our users download to their computers or that they rely on to store information and transmit information to others over the internet. These products and services are subject to attack by viruses, worms and other malicious software programs, which could jeopardize the security of information stored in a user's computer or in our

Edgar Filing: Google Inc. - Form 10-Q

computer systems and networks. The ability to reach users and provide them with a superior experience is critical to our success. If our efforts to combat these malicious applications are unsuccessful, or if our products and services have actual or perceived vulnerabilities, our reputation may be harmed and our user traffic could decline, which would damage our business.

Proprietary document formats may limit the effectiveness of our search technology by preventing our technology from accessing the content of documents in such formats, which could limit the effectiveness of our products and services.

A large amount of information on the internet is provided in proprietary document formats such as Microsoft Word. The providers of the software application used to create these documents could engineer the document format to prevent or interfere with our ability to access the document contents with our search technology. This would mean that the document contents would not be included in our search results even if the contents were directly relevant to a search. The software providers may also seek to require

Table of Contents

us to pay them royalties in exchange for giving us the ability to search documents in their format. If the software provider also competes with us in the search business, they may give their search technology a preferential ability to search documents in their proprietary format. Any of these results could harm our brand and our operating results.

New technologies could block our ads, which would harm our business.

Technologies may be developed that can block the display of our ads. Most of our revenues are derived from fees paid to us by advertisers in connection with the display of ads on web pages. As a result, ad-blocking technology could, in the future, adversely affect our operating results.

If we fail to detect click fraud or other invalid clicks, we could face additional litigation as well as lose the confidence of our advertisers, which would cause our business to suffer.

We are exposed to the risk of fraudulent clicks and other invalid clicks on our ads from a variety of potential sources. We have regularly refunded fees that our advertisers have paid to us that were later attributed to click fraud and other invalid clicks, and we expect to do so in the future. Invalid clicks are clicks that we have determined are not intended by the user to link to the underlying content, such as inadvertent clicks on the same ad twice and clicks resulting from click fraud. Click fraud occurs when a user intentionally clicks on a Google AdWords ad displayed on a web site for a reason other than to view the underlying content. If we are unable to stop these invalid clicks, these refunds may increase. If we find new evidence of past invalid clicks we may issue refunds retroactively of amounts previously paid to our Google Network members. This would negatively affect our profitability, and these invalid clicks could hurt our brand. If invalid clicks are not detected, the affected advertisers may experience a reduced return on their investment in our advertising programs because the invalid clicks will not lead to potential revenue for the advertisers. This could lead the advertisers to become dissatisfied with our advertising programs, which has led to litigation alleging click fraud and could lead to further litigation, as well as potentially leading to a loss of advertisers and revenues.

Index spammers could harm the integrity of our web search results, which could damage our reputation and cause our users to be dissatisfied with our products and services.

There is an ongoing and increasing effort by index spammers to develop ways to manipulate our web search results. For example, because our web search technology ranks a web page's relevance based in part on the importance of the web sites that link to it, people have attempted to link a group of web sites together to manipulate web search results. We take this problem very seriously because providing relevant information to users is critical to our success. If our efforts to combat these and other types of index spamming are unsuccessful, our reputation for delivering relevant information could be diminished. This could result in a decline in user traffic, which would damage our business.

If we were to lose the services of Eric, Larry, Sergey or other members of our senior management team, we may not be able to execute our business strategy.

Our future success depends in a large part upon the continued service of key members of our senior management team. In particular, our CEO Eric Schmidt and our founders Larry Page and Sergey Brin are critical to the overall management of Google as well as the development of our technology, our culture and our strategic direction. All of our executive officers and key employees are at-will employees, and we do not maintain any key-person life insurance policies. The loss of any of our management or key personnel could seriously harm our business.

We rely on highly skilled personnel and, if we are unable to retain or motivate key personnel or hire qualified personnel, we may not be able to grow effectively.

Our performance largely depends on the talents and efforts of highly skilled individuals. Our future success depends on our continuing ability to identify, hire, develop, motivate and retain highly skilled personnel for all areas of our organization. Competition in our industry for qualified employees is intense, and certain of our competitors have directly targeted our employees. Our continued ability to compete effectively depends on our ability to attract new employees and to retain and motivate our existing employees.

We have in the past maintained a rigorous, highly selective and time-consuming hiring process. We believe that our approach to hiring has significantly contributed to our success to date. As we grow, our hiring process may prevent us from hiring the personnel we need in a timely manner. In addition, as we become a more mature company, we may find our recruiting efforts more challenging. The incentives to attract, retain and motivate employees provided by our equity award grants may not be as effective as in the past. In addition, our other current and future compensation arrangements, which include cash bonuses and our TSO program, may not be successful in attracting new employees and retaining and motivating our existing employees. If we do not succeed in attracting excellent personnel or retaining or motivating existing personnel, we may be unable to grow effectively.

Table of Contents

We have a short operating history and a relatively new business model in an emerging and rapidly evolving market. This makes it difficult to evaluate our future prospects and may increase the risk that we will not continue to be successful.

We first derived revenue from our online search business in 1999 and from our advertising services in 2000, and we have only a short operating history with our cost-per-click advertising model, which we launched in 2002 and our cost-per-impression advertising model which we launched in the second quarter of 2005. As a result, we have very little operating history to aid in assessing our future prospects. Also, we derive nearly all of our revenues from online advertising, which is an immature industry that has undergone rapid and dramatic changes in its short history. We will encounter risks and difficulties as an early-stage company in a new and rapidly evolving market. We may not be able to successfully address these risks and difficulties, which could materially harm our business and operating results.

We may have difficulty scaling and adapting our existing architecture to accommodate increased traffic and technology advances or changing business requirements, which could lead to the loss of users, advertisers and Google Network members, and cause us to incur expenses to make architectural changes.

To be successful, our network infrastructure has to perform well and be reliable. The greater the user traffic and the greater the complexity of our products and services, the more computing power we will need. We have spent and expect to continue to spend substantial amounts on the purchase and lease of data centers and equipment and the upgrade of our technology and network infrastructure to handle increased traffic on our web sites and to roll out new products and services. This expansion is expensive and complex and could result in inefficiencies or operational failures. If we do not expand successfully, or if we experience inefficiencies and operational failures, the quality of our products and services and our users' experience could decline. This could damage our reputation and lead us to lose current and potential users, advertisers and Google Network members. Cost increases, loss of traffic or failure to accommodate new technologies or changing business requirements could harm our operating results and financial condition.

We rely on bandwidth providers, data centers or others in providing products and services to our users, and any failure or interruption in the services and products provided by these third parties could harm our ability to operate our business and damage our reputation.

We rely on vendors, including data center and bandwidth providers. Any disruption in the network access or colocation services provided by these providers or any failure of these providers to handle current or higher volumes of use could significantly harm our business. Any financial or other difficulties our providers face may have negative effects on our business. We exercise little control over these vendors, which increases our vulnerability to problems with the services they provide. We license technology and related databases to facilitate aspects of our data center and connectivity operations including internet traffic management services. We have experienced and expect to continue to experience interruptions and delays in service and availability for such elements. Any errors, failures, interruptions or delays in connection with these technologies and information services could harm our relationship with users, adversely affect our brand and expose us to liabilities.

Our systems are also heavily reliant on the availability of electricity. If we were to experience a major power outage, we would have to rely on back-up generators. These back-up generators may not operate properly and their fuel supply could be inadequate during a major power outage. This could result in a disruption of our business.

Our business depends on continued and unimpeded access to the internet by us and our users. Internet access providers may be able to block, degrade or charge for access to certain of our products and services, which could lead to additional expenses and the loss of users and advertisers.

Our products and services depend on the ability of our users to access the internet, and certain of our products require significant bandwidth to work effectively. Currently, this access is provided by companies that have significant and increasing market power in the broadband and internet access marketplace, including incumbent telephone companies, cable companies and mobile communications companies. Some of these providers have stated that they may take measures that could degrade, disrupt or increase the cost of user access to certain of our products by restricting or prohibiting the use of their infrastructure to support or facilitate our offerings, or by charging increased fees to us or our users to provide our offerings. These activities may be permitted in the U.S. after recent regulatory changes, including recent decisions by the U.S. Supreme Court and Federal Communications Commission and under legislation being considered by the U.S. Congress. While interference with access to our popular products and services seems unlikely, such carrier interference could result in a loss of existing users and advertisers, increased costs, and impair our ability to attract new users and advertisers, thereby harming our revenue and growth.

Interruption or failure of our information technology and communications systems could hurt our ability to effectively provide our products and services, which could damage our reputation and harm our operating results.

Edgar Filing: Google Inc. - Form 10-Q

The availability of our products and services depends on the continuing operation of our information technology and communications systems. Any damage to or failure of our systems could result in interruptions in our service, which could reduce our revenues and profits, and damage our brand. Our systems are vulnerable to damage or interruption from earthquakes, terrorist attacks, floods, fires, power loss, telecommunications failures, computer viruses, computer denial of service attacks or other attempts to harm our systems. Some of our data centers are located in areas with a high risk of major earthquakes. Our data centers are also subject to break-ins, sabotage and intentional acts of vandalism, and to potential disruptions if the operators of these facilities have financial

Table of Contents

difficulties. Some of our systems are not fully redundant, and our disaster recovery planning cannot account for all eventualities. The occurrence of a natural disaster, a decision to close a facility we are using without adequate notice for financial reasons or other unanticipated problems at our data centers could result in lengthy interruptions in our service.

Our business depends on increasing use of the internet by users searching for information, advertisers marketing products and services and web sites seeking to earn revenue to support their web content. If the internet infrastructure does not grow and is not maintained to support these activities, our business will be harmed.

Our success will depend on the continued growth and maintenance of the internet infrastructure. This includes maintenance of a reliable network backbone with the necessary speed, data capacity and security for providing reliable internet services. Internet infrastructure may be unable to support the demands placed on it if the number of internet users continues to increase, or if existing or future internet users access the internet more often or increase their bandwidth requirements. In addition, viruses, worms and similar programs may harm the performance of the internet. The internet has experienced a variety of outages and other delays as a result of damage to portions of its infrastructure, and could face outages and delays in the future. These outages and delays could reduce the level of internet usage as well as our ability to provide our solutions.

More individuals are using non-PC devices to access the internet, and versions of our web search technology developed for these devices may not be widely adopted by users of these devices.

The number of people who access the internet through devices other than personal computers, including mobile telephones, hand-held calendaring and email assistants, and television set-top devices, has increased dramatically in the past few years. The lower resolution, functionality and memory associated with alternative devices make the use of our products and services through such devices more difficult. If we are unable to attract and retain a substantial number of alternative device users to our web search services or if we are slow to develop products and technologies that are more compatible with non-PC communications devices, we will fail to capture a significant share of an increasingly important portion of the market for online services.

Payments to certain of our Google Network members have exceeded the related fees we receive from our advertisers.

We are obligated under certain agreements to make non-cancelable guaranteed minimum revenue share payments to Google Network members based on their achieving defined performance terms, such as number of search queries or advertisements displayed. In these agreements, we promise to make these minimum payments to the Google Network member for a pre-negotiated period of time. At March 31, 2007, our aggregate outstanding non-cancelable guaranteed minimum revenue share commitments totaled \$1.27 billion through 2011 compared to \$1.17 billion at December 31, 2006. It is difficult to forecast with certainty the fees that we will earn under agreements with guarantees, and sometimes the fees we earn fall short of the guaranteed minimum payment amounts.

We rely on outside providers for our worldwide billing, collection, payment processing and payroll. If these outside service providers are not able to fulfill their service obligations, our business and operations could be disrupted, and our operating results could be harmed.

Outside providers perform various functions for us, such as worldwide billing, collection, payment processing and payroll. These functions are critical to our operations and involve sensitive interactions between us and our advertisers, partners (e.g., Google Network members) and employees. While we have implemented service level agreements and have established monitoring controls, however if we do not successfully manage our service providers or if the service providers do not perform satisfactorily to agreed upon service levels, our operations could be disrupted resulting in advertiser, partner or employee dissatisfaction. In addition, our business, reputation and operating results could be adversely affected.

To the extent our revenues are paid in foreign currencies, and currency exchange rates become unfavorable, we may lose some of the economic value of the revenues in U.S. dollar terms.

As we expand our international operations, more of our customers may pay us in foreign currencies. Conducting business in currencies other than U.S. dollars subjects us to fluctuations in currency exchange rates. If the currency exchange rates were to change unfavorably, the value of net receivables we receive in foreign currencies and later convert to U.S. dollars after the unfavorable change would be diminished. This could have a negative impact on our reported operating results. Hedging strategies, such as forward contracts, options and foreign exchange swaps related to transaction exposures, that we have implemented or may implement to mitigate this risk may not eliminate our exposure to foreign exchange fluctuations. Additionally, hedging programs expose us to risks that could adversely affect our operating results, including the following:

Edgar Filing: Google Inc. - Form 10-Q

We have limited experience in implementing or operating hedging programs. Hedging programs are inherently risky and we could lose money as a result of poor trades.

We may be unable to hedge currency risk for some transactions because of a high level of uncertainty or the inability to reasonably estimate our foreign exchange exposures.

Table of Contents

We may be unable to acquire foreign exchange hedging instruments in some of the geographic areas where we do business, or, where these derivatives are available, we may not be able to acquire enough of them to fully offset our exposure.

We may have exposure to greater than anticipated tax liabilities.

Our future income taxes could be adversely affected by earnings being lower than anticipated in jurisdictions where we have lower statutory rates and higher than anticipated in jurisdictions where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities or by changes in tax laws, regulations, accounting principles or interpretations thereof. Our determination of our tax liability is always subject to review by applicable tax authorities. Any adverse outcome of such a review could have a negative effect on our operating results and financial condition. In addition, the determination of our worldwide provision for income taxes and other tax liabilities requires significant judgment and there are many transactions and calculations where the ultimate tax determination is uncertain. Although we believe our estimates are reasonable, the ultimate tax outcome may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods for which such determination is made.

Risks Related to Ownership of our Common Stock

The trading price for our Class A common stock has been and may continue to be volatile.

The trading price of our Class A common stock has been volatile since our initial public offering and will likely continue to be volatile. The trading price of our Class A common stock may fluctuate widely in response to various factors, some of which are beyond our control. These factors include:

Quarterly variations in our results of operations or those of our competitors.

Announcements by us or our competitors of acquisitions, new products, significant contracts, commercial relationships or capital commitments.

Recommendations by securities analysts or changes in earnings estimates.

Announcements about our earnings that are not in line with analyst expectations, the risk of which is enhanced because it is our policy not to give guidance on earnings.

Announcements by our competitors of their earnings that are not in line with analyst expectations.

The volume of shares of Class A common stock available for public sale.

Sales of stock by us or by our stockholders.

Short sales, hedging and other derivative transactions on shares of our Class A common stock, which will increase due to our TSO program.

In addition, the stock market in general, and the market for technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may seriously harm the market price of our Class A common stock, regardless of our actual operating performance. In the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

We do not intend to pay dividends on our common stock.

We have never declared or paid any cash dividend on our capital stock. We currently intend to retain any future earnings and do not expect to pay any dividends in the foreseeable future.

The concentration of our capital stock ownership with our founders, executive officers and our directors and their affiliates will limit our stockholders ability to influence corporate matters.

Our Class B common stock has ten votes per share and our Class A common stock has one vote per share. As of March 31, 2006, our founders, executive officers and directors (and their affiliates) together owned shares of Class A common stock, Class B common stock and other equity interests representing approximately 73% of the voting power of our outstanding capital stock. In particular, as of March 31, 2006, our two founders and our CEO, Larry, Sergey and Eric, owned approximately 86% of our outstanding Class B common stock, including options to purchase Class B common stock, representing approximately 67% of the voting power of our outstanding capital stock. Larry, Sergey and Eric therefore have significant influence over management and affairs and over all matters requiring stockholder approval, including the election of directors and significant corporate transactions, such as a merger or other sale of our company or its assets, for the foreseeable future. In addition, because of this dual class structure, our founders, directors, executives and employees will continue to be able to control all matters submitted to our stockholders for approval even if they come to own less than 50% of the outstanding shares of our common stock. This concentrated control limits our stockholders ability to influence corporate matters and, as a result, we may take actions that our stockholders do not view as beneficial. As a result, the market price of our Class A common stock could be adversely affected.

Table of Contents

Provisions in our charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

Our certificate of incorporation provides for a dual class common stock structure. As a result of this structure our founders, executives and employees have significant influence over all matters requiring stockholder approval, including the election of directors and significant corporate transactions, such as a merger or other sale of our company or its assets. This concentrated control could discourage others from initiating any potential merger, takeover or other change of control transaction that other stockholders may view as beneficial.

Our board of directors has the right to elect directors to fill a vacancy created by the expansion of the board of directors or the resignation, death or removal of a director, which prevents stockholders from being able to fill vacancies on our board of directors.

Our stockholders may not act by written consent. As a result, a holder, or holders, controlling a majority of our capital stock would not be able to take certain actions without holding a stockholders meeting.

Our certificate of incorporation prohibits cumulative voting in the election of directors. This limits the ability of minority stockholders to elect director candidates.

Stockholders must provide advance notice to nominate individuals for election to the board of directors or to propose matters that can be acted upon at a stockholders meeting. These provisions may discourage or deter a potential acquiror from conducting a solicitation of proxies to elect the acquiror's own slate of directors or otherwise attempting to obtain control of our company.

Our board of directors may issue, without stockholder approval, shares of undesignated preferred stock. The ability to issue undesignated preferred stock makes it possible for our board of directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us.

As a Delaware corporation, we are also subject to certain Delaware anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on Delaware law to prevent or delay an acquisition of us.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS*****Purchases of Equity Securities by Google***

Pursuant to the terms of our 1998 Stock Plan, 2000 Stock Plan, 2003 Stock Plan, 2003 Stock Plan (No. 2), 2003 Stock Plan (No. 3), 2004 Stock Plan and equity incentive plans assumed through acquisitions (collectively referred to as our Stock Plans), options may typically be exercised prior to vesting. We have the right to repurchase unvested shares from service providers upon their termination, and it is generally our policy to do so. The following table provides information with respect to purchases made by us of shares of our common stock during the three month period ended March 31, 2007:

Period	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased
			Purchased as Part of Publicly Announced Plans or Programs	Under the Plans or Programs
January 1 - 31	454	\$ 5.00		
February 1 - 28	200	\$ 0.30		
March 1 - 31	8,267	\$ 3.57		
Total	8,921	\$ 3.57		

- (1) All shares were originally purchased from us by employees pursuant to exercises of unvested stock options. During the months listed above, we routinely repurchased the shares from our service providers upon their termination of employment pursuant to our right to repurchase unvested shares at the original exercise price under the terms of our Stock Plans and the related stock option agreements.

Table of Contents**ITEM 6. EXHIBITS**

Exhibit Number	Description	Incorporated by reference herein	
		Form	Date
10.05	♥* 2003 Stock Plan, as amended		
10.06	♥* 2003 Stock Plan (No. 2), as amended		
10.07	♥* 2003 Stock Plan (No. 3), as amended		
10.08	♥* Google Inc. 2004 Stock Plan, as amended		
10.22.1	* Amended and Restated Agreement and Plan of Merger by and among Google Inc., Snowmass Holdings Inc., YouTube, Inc. and certain other parties dated as of November 3, 2006, as amended		
10.23	♥ Google Inc. Executive Bonus Plan	Current Report on Form 8-K	March 28, 2007
31.01	* Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003		
31.02	* Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003		
32.01	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2003		

-
- ♥ Indicates management compensatory plan, contract or arrangement.
Confidential treatment has been requested for portions of this exhibit.
- * Filed herewith.
Furnished herewith.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

GOOGLE INC.

Date: May 9, 2007

By: /s/ Eric Schmidt
Eric Schmidt

**Chairman of the Executive Committee
and Chief Executive Officer**

Table of Contents**EXHIBIT INDEX**

Exhibit Number	Description	Incorporated by reference herein	
		Form	Date
10.05	♥* 2003 Stock Plan, as amended		
10.06	♥* 2003 Stock Plan (No. 2), as amended		
10.07	♥* 2003 Stock Plan (No. 3), as amended		
10.08	♥* Google Inc. 2004 Stock Plan, as amended		
10.22.1	* Amended and Restated Agreement and Plan of Merger by and among Google Inc., Snowmass Holdings Inc., YouTube, Inc. and certain other parties dated as of November 3, 2006, as amended		
10.23	♥ Google Inc. Executive Bonus Plan	Current Report on Form 8-K	March 28, 2007
31.01	* Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003		
31.02	* Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003		
32.01	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2003		
<hr/>			
♥	Indicates management compensatory plan, contract or arrangement. Confidential treatment has been requested for portions of this exhibit.		
*	Filed herewith. Furnished herewith.		