

SOHU COM INC  
Form 10-Q  
August 08, 2006  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

---

**FORM 10-Q**

---

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006**  
**OR**

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

**FOR THE TRANSITION PERIOD FROM            TO**  
**COMMISSION FILE NUMBER 0-30961**

---

**Sohu.com Inc.**

**(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)**

---

**Delaware**  
**(STATE OR OTHER JURISDICTION OF**

**INCORPORATION OR ORGANIZATION)**

**Level 12, Vision International Center**

**98-0204667**  
**(I.R.S. EMPLOYER**

**IDENTIFICATION NUMBER)**

Edgar Filing: SOHU COM INC - Form 10-Q

No. 1 Unit Zhongguancun East Road, Haidian District

Beijing 100084

People's Republic of China

(011) 8610-6272-6666

(Address, including zip code, of registrant's principal executive offices  
and 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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Class	Outstanding at July 31, 2006
Common stock, \$.001 par value	37,077,222

---

**Table of Contents****SOHU.COM INC****Table of Contents**

	<b>PAGE</b>
<b>PART I</b>	
<b><u>FINANCIAL INFORMATION</u></b>	
Item 1	1
	1
	2
	3
	4
	5
Item 2	17
Item 3	50
Item 4	51
<b>PART II</b>	
<b><u>OTHER INFORMATION</u></b>	
Item 1	52
Item 2	52
Item 3	52
Item 4	52
Item 5	52
Item 6	52
	53
	54

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****SOHU.COM INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands)**

	<b>June 30,</b>	<b>As of December 31,</b>
	<b>2006</b>	<b>2005</b>
	<b>(unaudited)</b>	<b>(audited)</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 119,018	\$ 119,091
Accounts receivable, net (including \$325 and \$358 from a related party, respectively)	23,749	19,283
Prepaid and other current assets	4,045	4,546
Current portion of long-term investments in marketable debt securities	9,004	9,095
<b>Total current assets</b>	<b>155,816</b>	<b>152,015</b>
Long-term investments in marketable debt securities	4,876	4,900
Investment in an associate	1,214	1,124
Fixed assets, net	16,717	15,745
Goodwill	51,440	50,918
Intangible assets, net	9,688	11,251
Restricted cash	1,001	991
Other assets, net	3,438	2,737
	<b>\$ 244,190</b>	<b>\$ 239,681</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable (including \$45 and \$81 to a related party, respectively)	\$ 1,421	\$ 1,683
Accrued liabilities	33,501	33,370
<b>Total current liabilities</b>	<b>34,922</b>	<b>35,053</b>
Zero coupon convertible senior notes	59,780	74,780
<b>Total liabilities</b>	<b>94,702</b>	<b>109,833</b>
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Common stock: \$0.001 par value per share (75,400 authorized; 37,006 and 36,680 shares issued and outstanding, respectively)	40	40
Additional paid-in capital	154,205	148,780
Treasury stock (3,446 shares and 3,446 shares, respectively)	(39,686)	(39,686)
Accumulated other comprehensive income	3,131	2,126
Retained earnings	31,798	18,588
<b>Total shareholders' equity</b>	<b>149,488</b>	<b>129,848</b>

\$ 244,190 \$ 239,681

The accompanying notes are an integral part of these condensed consolidated financial statements.

-1-

**Table of Contents****SOHU.COM INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)****(In thousands, except per share data)**

	Three Months		Six Months	
	Ended		Ended	
	June 30,	June 30,	June 30,	June 30,
	2006	2005	2006	2005
Revenues:				
Advertising:				
Brand advertising	\$ 19,304	\$ 13,859	\$ 35,979	\$ 25,983
Sponsored search	3,526	3,105	6,976	5,836
Subtotal of advertising revenues	22,830	16,964	42,955	31,819
Non-advertising:				
Wireless	8,994	6,360	17,003	12,319
Others	2,250	1,714	4,530	3,360
Subtotal of non-advertising revenues	11,244	8,074	21,533	15,679
Total revenues	34,074	25,038	64,488	47,498
Cost of revenues:				
Advertising:				
Brand advertising (includes share-based compensation expense under SFAS 123(R) of \$264, \$0, \$603 and \$0, respectively)	5,610	3,407	9,941	6,217
Sponsored search (includes share-based compensation expense under SFAS 123(R) of \$22, \$0, \$44 and \$0, respectively)	1,247	699	2,339	1,180
Subtotal of advertising cost of revenues	6,857	4,106	12,280	7,397
Non-advertising:				
Wireless	4,464	2,871	8,276	5,193
Others (includes share-based compensation expense under SFAS 123(R) of \$5, \$0, \$10 and \$0, respectively)	826	675	1,618	1,348
Subtotal of non-advertising cost of revenues	5,290	3,546	9,894	6,541
Total cost of revenues	12,147	7,652	22,174	13,938
Gross profit	21,927	17,386	42,314	33,560
Operating expenses:				
Product development (includes share-based compensation expense under SFAS 123(R) of \$369, \$0, \$862 and \$0, respectively)	4,617	3,594	8,860	6,736
Sales and marketing (includes share-based compensation expense under SFAS 123(R) of \$298, \$0, \$746 and \$0, respectively)	7,033	4,012	13,407	8,439
General and administrative (includes share-based compensation expense under SFAS 123(R) of \$313, \$0, \$737 and \$0, respectively)	3,199	2,409	6,275	4,899
Amortization of intangible assets	509	474	1,018	930
Total operating expenses	15,358	10,489	29,560	21,004

Edgar Filing: SOHU COM INC - Form 10-Q

Operating profit	6,569	6,897	12,754	12,556
Other income (expenses)	711	(92)	643	(262)
Interest income	787	555	1,316	1,128
Income before income tax expense	8,067	7,360	14,713	13,422
Income tax expense	(303)	(50)	(746)	(112)
Income from continuing operations	7,764	7,310	13,967	13,310
Loss from discontinued e-commerce operations (Note 1)	(592)	(210)	(757)	(496)
Net income	\$ 7,172	\$ 7,100	\$ 13,210	\$ 12,814
Basic net income per share (Note 5)	\$ 0.19	\$ 0.20	\$ 0.36	\$ 0.36
Shares used in computing basic net income per share	36,943	36,015	36,856	36,093
Diluted net income per share (Note 5)	\$ 0.19	\$ 0.18	\$ 0.34	\$ 0.33
Shares used in computing diluted net income per share	39,474	39,596	39,430	39,764

Effective from January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (or SFAS 123(R)), which requires all share-based awards to employees and directors to be recognized in the financial statements based on their grant date fair values. Net income for the three and six months ended June 30, 2006 included share-based compensation expense under SFAS 123(R) of \$1.3 million and \$3.0 million, respectively. Please refer to Note 6 to the Condensed Consolidated Financial Statements for additional information.

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****SOHU.COM INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)****(In thousands)**

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 13,210	\$ 12,814
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation	2,664	2,395
Amortization of intangible assets and other assets	2,041	1,730
Provision for allowance for doubtful accounts	756	640
Share-based compensation expense due to the implementation of SFAS 123(R)	3,002	
Gains on early redemption of zero coupon convertible senior notes	(793)	
Others	208	51
<b>Changes in assets and liabilities:</b>		
Accounts receivable	(4,932)	(2,233)
Prepaid and other current assets	(58)	794
Accounts payable	(262)	(631)
Accrued liabilities	(181)	(4,033)
<b>Net cash provided by operating activities</b>	<b>15,655</b>	<b>11,527</b>
<b>Cash flows from investing activities:</b>		
Proceeds from maturities of marketable debt securities		3,149
Purchase of fixed assets	(3,711)	(5,501)
Purchase of other assets	(854)	(304)
Acquisitions, net of cash acquired	(306)	(10,182)
<b>Net cash used in investing activities</b>	<b>(4,871)</b>	<b>(12,838)</b>
<b>Cash flows from financing activities:</b>		
Repurchase of common stock		(13,847)
Early redemption of zero coupon convertible senior notes	(14,062)	
Issuance of common stock	2,424	1,892
<b>Net cash used in financing activities</b>	<b>(11,638)</b>	<b>(11,955)</b>
Effect of exchange rate change on cash and cash equivalents	781	
<b>Net decrease in cash and cash equivalents</b>	<b>(73)</b>	<b>(13,266)</b>
Cash and cash equivalents at beginning of period	119,091	122,384
<b>Cash and cash equivalents at end of period</b>	<b>\$ 119,018</b>	<b>\$ 109,118</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.



**Table of Contents****SOHU.COM INC.****CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY (unaudited)**

(In thousands)

	Six Months Ended June 30,	
	2006	2005
<b>Common stock:</b>		
Balance, beginning of period	\$ 40	\$ 38
Issuance of common stock		1
Balance, end of period	40	39
<b>Additional paid-in capital:</b>		
Balance, beginning of period	148,780	145,481
Issuance of common stock	2,423	1,891
Tax benefit from stock options		93
Compensatory stock options	3,002	
Balance, end of period	154,205	147,465
<b>Treasury stock:</b>		
Balance, beginning of period	(39,686)	(25,839)
Repurchase of common stock		(13,847)
Balance, end of period	(39,686)	(39,686)
<b>Deferred compensation:</b>		
Balance, beginning of period		(2)
Compensatory stock options		2
Balance, end of period		
<b>Accumulated other comprehensive income:</b>		
Balance, beginning of period	2,126	14
Net unrealized gains (losses) on marketable debt securities	10	(74)
Foreign currency translation adjustment	995	(5)
Balance, end of period	3,131	(65)
<b>Retained earnings (accumulated deficit):</b>		
Balance, beginning of period	18,588	(11,193)
Net income	13,210	12,814
Balance, end of period	31,798	1,621
Total stockholders' equity	\$ 149,488	\$ 109,374
<b>Comprehensive income:</b>		
Net income	\$ 13,210	\$ 12,814
<b>Other comprehensive income:</b>		

Edgar Filing: SOHU COM INC - Form 10-Q

Net unrealized gains (losses) on marketable debt securities	10	(74)
Foreign currency translation adjustment	995	(5)
Total comprehensive income	\$ 14,215	\$ 12,735

	<b>Number of Outstanding Shares</b>	
<b>Common stock:</b>		
Balance, beginning of period	36,680	36,537
Issuance of common stock	326	584
Repurchase of common stock		(886)
Balance, end of period	37,006	36,235

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents**

**SOHU.COM INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. THE COMPANY AND BASIS OF PRESENTATION**

Sohu.com Inc. (the Company or Sohu) is a leading online media, search and mobile value-added services company providing comprehensive online products and services to consumers and businesses in the People's Republic of China (the PRC or China). The Company, a Delaware corporation, commenced operations in 1996.

The Company and its variable interest entities (or VIEs) primarily offer content, brand advertising, sponsored search, wireless and online game services through the Company's Internet sites, www.sohu.com, www.sogou.com, www.chinaren.com, www.17173.com, www.focus.cn, www.goodfeel.com.cn and www.go2map.com. The Company markets its products and services to consumers and businesses primarily in the PRC.

The accompanying unaudited condensed consolidated interim financial statements reflect all normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results for the interim periods presented. Results for the three and six months ended June 30, 2006 are not necessarily indicative of the results expected for the full fiscal year or for any future period.

These financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

*Discontinuance of E-commerce Operation*

The Company discontinued its e-commerce platform of physical consumer goods on June 20, 2006, in order to focus on profitable segments. As a result of the disposal, the e-commerce business is accounted for as a discontinued operation. Accordingly, the Company's statements of operations separate the discontinued operation for all periods presented. For the three and six months ended June 30, 2006, revenues from e-commerce operation amounted to \$37,000 and \$875,000, respectively, as compared to \$841,000 and \$2.1 million during the three and six months ended June 30, 2005. For the three and six months ended June 30, 2006, net loss from e-commerce operation amounted to \$592,000 and \$757,000, respectively, as compared to \$210,000 and \$496,000 during the three and six months ended June 30, 2005.

At the discontinuance of e-commerce operation, the Company had performed a specific review on all the assets related to e-commerce segment, and provided full provisions for doubtful receivables and the entire inventory balances. As the fixed assets previously used by the e-commerce operation could generally be used by other segments, we did not dispose significant fixed assets nor provide impairment on the fixed assets.

*Accounting Policies on Share-based Payments Effective from January 1, 2006*

Effective from January 1, 2006, the Company adopted SFAS 123(R), which requires all share-based awards to employees and directors, including grants of employee stock options, to be recognized in the financial statements based on their grant date fair values. The valuation provisions of SFAS 123(R) apply to new awards, to awards granted before the adoption of SFAS 123(R) whose related requisite services had not been provided,

---

**Table of Contents**

**SOHU.COM INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

and to awards which were subsequently modified or cancelled. In March 2005, the Securities and Exchange Commission (or SEC) issued Staff Accounting Bulletin No. 107 (or SAB 107) regarding the SEC's interpretation of SFAS 123(R) and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). Prior to January 1, 2006, the Company accounted for share-based payments in accordance with APB No. 25, Accounting for Stock Issued to Employees (or APB 25), and complied with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation (or SFAS 123). In general, compensation cost under APB 25 was recognized based on the difference, if any, between the estimated fair value of the common stock and the amount an employee must pay to acquire the stock, as determined on the date the option is granted. Pro forma information was disclosed to illustrate the effects on net income and net income per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the reporting periods.

Under SFAS 123(R), the Company applied the Black-Scholes valuation model in determining the fair value of option granted to employees and directors. Under the transition provisions of SFAS 123(R), the Company recognizes compensation expense on options granted prior to the adoption of SFAS 123(R) on an accelerated basis over the requisite service period, which is consistent with the methods the Company adopted when preparing pro forma information under SFAS 123. Under SFAS 123(R), the number of share-based awards for which the service is not expected to be rendered for the requisite period should be estimated, and the related compensation cost not recorded for that number of awards. For pro forma disclosure under SFAS 123, the effect of forfeitures was accounted for only as the forfeitures occurred. The Company applied the modified prospective transition method, and therefore has not restated prior periods' results. There were no options or other share-based awards granted during the six months ended June 30, 2006.

*Reclassification*

In January 2006, the Company reclassified software and domain names from other assets to intangible assets for better presentation. To conform with the current period presentation, the relevant amounts as of December 31, 2005 have been reclassified. Such reclassification has increased the net balance of intangible assets and decreased the net balance of other assets as of December 31, 2005 by \$3.0 million.

**2. SEGMENT INFORMATION**

Based on the criteria established by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, the Company mainly operated in four principal segments during the six months ended June 30, 2006: brand advertising, sponsored search, wireless and e-commerce. In June 2006, the Company had terminated its e-commerce business. Accordingly, the results of operations for e-commerce have been reclassified as loss from discontinued operation for all periods presented.

In years prior to 2005, the Company had included all of its Website operating cost in cost of revenues of brand advertising. In July 2005, in order to improve measurement of the performance of each segment, the Company began allocating Website operating cost to the cost of revenues of each segment based on actual usage. Accordingly, the Company reclassified the cost of revenues amongst each segment for the previous period presented to conform with the current period classification. The Company does not allocate any operating expenses or assets to its brand advertising, sponsored search, wireless and other segments as management does not use this information to measure the performance of the operating segments. Management does not consider share-based compensation for their segment reporting as shown in the tables, as such information does not impact the decisions on resource allocation and segment performance evaluation.

**Table of Contents****SOHU.COM INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following tables present summary information by segment (in thousands):

	<b>For the three months ended June 30, 2006</b>				
	<b>Brand Advertising</b>	<b>Sponsored Search</b>	<b>Wireless</b>	<b>Others*</b>	<b>Total</b>
Revenues	\$ 19,304	\$ 3,526	\$ 8,994	\$ 2,250	\$ 34,074
Segment cost of revenues	(5,346)	(1,225)	(4,464)	(821)	(11,856)
Segment gross profit	\$ 13,958	\$ 2,301	\$ 4,530	\$ 1,429	22,218
Share-based compensation expense under SFAS 123(R)					(291)
Gross Profit					\$ 21,927

	<b>For the three months ended June 30, 2005</b>				
	<b>Brand Advertising</b>	<b>Sponsored Search</b>	<b>Wireless</b>	<b>Others*</b>	<b>Total</b>
Revenues	\$ 13,859	\$ 3,105	\$ 6,360	\$ 1,714	\$ 25,038
Segment cost of revenues	(3,407)	(699)	(2,871)	(675)	(7,652)
Segment gross profit	\$ 10,452	\$ 2,406	\$ 3,489	\$ 1,039	\$ 17,386

	<b>For the six months ended June 30, 2006</b>				
	<b>Brand Advertising</b>	<b>Sponsored Search</b>	<b>Wireless</b>	<b>Others*</b>	<b>Total</b>
Revenues	\$ 35,979	\$ 6,976	\$ 17,003	\$ 4,530	\$ 64,488
Segment cost of revenues	(9,338)	(2,295)	(8,276)	(1,608)	(21,517)
Segment gross profit	\$ 26,641	\$ 4,681	\$ 8,727	\$ 2,922	42,971
Share-based compensation expense under SFAS 123(R)					(657)
Gross Profit					\$ 42,314

	<b>For the six months ended June 30, 2005</b>				
	<b>Brand Advertising</b>	<b>Sponsored Search</b>	<b>Wireless</b>	<b>Others*</b>	<b>Total</b>
Revenues	\$ 25,983	\$ 5,836	\$ 12,319	\$ 3,360	\$ 47,498
Segment cost of revenues	(6,217)	(1,180)	(5,193)	(1,348)	(13,938)
Segment gross profit	\$ 19,766	\$ 4,656	\$ 7,126	\$ 2,012	\$ 33,560

---

\* Revenues of Go2Map since May 31, 2005, the date of acquisition, mainly comprising sales of software and provision of application services, are included in others.

**Table of Contents****SOHU.COM INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****3. OTHER INCOME (EXPENSES)**

The following table summarizes the Company's other income (expenses) (in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Gains on early redemption of zero coupon convertible senior notes*	\$ 793	\$	\$ 793	\$
Amortization of offering costs for zero coupon convertible senior notes	(134)	(187)	(289)	(374)
Shares of profits from investment in an associate	42	25	80	42
Others	10	70	59	70
	<b>\$711</b>	<b>\$ (92)</b>	<b>\$ 643</b>	<b>\$ (262)</b>

\* During the three months ended June 30, 2006, the Company made an early redemption of zero coupon convertible senior notes with face value of \$15.0 million at a discount, resulting in a gain of \$793,000.

**4. INCOME TAX EXPENSE**

The Company is subject to taxes in the United States at 34% or 35%, depending upon taxable income levels. Certain of the Company's subsidiaries are subject to taxes in Hong Kong at 17.5% and certain subsidiaries are subject to taxes in China as disclosed below. The Company's subsidiaries in China are governed by the Income Tax Law of the People's Republic of China concerning Foreign Investment Enterprises and Foreign Enterprises and local income tax laws (the PRC Income Tax Law). Pursuant to the PRC Income Tax Law, wholly-owned foreign enterprises are subject to tax at a statutory rate of 33% (30% state income tax plus 3% local income tax), or 15% for certain technology enterprises, on PRC taxable income. Furthermore, new technology enterprises are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction, at the rate of 7.5%, for the subsequent three years and 15% thereafter.

Starting from January 1, 2006, most operations of the Company in the PRC have finished their tax exemption periods, and therefore are subject to a 7.5% PRC income tax rate. Total PRC income tax expense for the three and six months ended June 30, 2006 amounted to \$303,000 and \$762,000, respectively, as compared to \$7,000 and \$13,000 for the corresponding three and six month periods in 2005.

**5. NET INCOME PER SHARE**

Basic net income per share is computed using the weighted average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted average number of common and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of shares issuable upon the exercise of stock options (using the treasury stock method) and zero coupon convertible senior notes.

**Table of Contents****SOHU.COM INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table presents the calculation of basic and diluted net income per share (in thousands, except per share data):

	Three months Ended		Six Months Ended	
	June 30, 2006	2005	June 30, 2006	2005
<b>Numerator:</b>				
Income from continuing operations	\$ 7,764	\$ 7,310	\$ 13,967	\$ 13,310
Loss from discontinued e-commerce operations	(592)	(210)	(757)	(496)
Net income	7,172	7,100	13,210	12,814
<b>Effect of dilutive securities:</b>				
Amortization of offering costs for zero coupon convertible senior notes	134	187	289	374
Net income adjusted for dilutive securities	\$ 7,306	\$ 7,287	\$ 13,499	\$ 13,188
<b>Denominator:</b>				
Weighted average basic common shares outstanding	36,943	36,015	36,856	36,093
<b>Effect of dilutive securities:</b>				
Stock options	1,081	1,570	1,013	1,660
Zero coupon convertible senior notes	1,450	2,011	1,561	2,011
Weighted average diluted common shares outstanding	39,474	39,596	39,430	39,764
Basic income per share from continuing operations	\$ 0.21	\$ 0.20	\$ 0.38	\$ 0.37
Basic loss per share from discontinued e-commerce operations	(0.02)	(0.00)	(0.02)	(0.01)
Basic net income per share	\$ 0.19	\$ 0.20	\$ 0.36	\$ 0.36
Diluted income per share from continuing operations	\$ 0.20	\$ 0.19	\$ 0.36	\$ 0.34
Diluted loss per share from discontinued e-commerce operations	(0.01)	(0.01)	(0.02)	(0.01)
Diluted net income per share	\$ 0.19	\$ 0.18	\$ 0.34	\$ 0.33

**6. SHARE-BASED COMPENSATION EXPENSE**

The Company's 2000 Stock Incentive Plan provides for the issuance of up to 9,500,000 shares of common stock. The maximum term of any issued stock right is ten years from the grant date.

The Company has reserved 9,500,000 shares of new common stock for issuance under the Company's 2000 Stock Incentive Plan. As of June 30, 2006, 1,471,383 shares were available for grant under the plan.



## Edgar Filing: SOHU COM INC - Form 10-Q

In accordance with SFAS 123(R), effective from January 1, 2006, all share-based payments to employees and directors are recognized in the financial statements based on their grant date fair values. The valuation provisions of SFAS 123(R) apply to new awards, to awards granted to employees and directors before the adoption of SFAS 123(R) whose related requisite services had not been provided, and to awards which were subsequently modified or cancelled. In March 2005, the SEC issued SAB 107 regarding the SEC's interpretation of SFAS 123(R) and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Under SFAS 123(R), the Company applied the Black-Scholes valuation model in determining the fair value of options granted. Under the transition provisions of SFAS 123(R), the Company recognizes compensation

**Table of Contents****SOHU.COM INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

expense on options granted prior to SFAS 123(R) on an accelerated basis over the vesting period of the underlying options, generally ranging from one to four years. Risk free interest rates are decided based on the yield to maturity of US government bonds as at the respective dates of grant of options. Expected life is the number of years that the Company estimates, based primarily on the history, using the plain-vanilla method, that options will be outstanding prior to settlement. Volatility is measured using historical daily price changes of the Company's stock over the respective expected life of the options. Forfeiture rate is estimated based on historical forfeiture patterns and adjusted in accordance with our expectation for the future. There were no options or other share-based awards granted during the six months ended June 30, 2006.

Estimates of fair value are not intended to predict actual future events or the value that ultimately will be realized by employees who receive equity awards, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by the Company under SFAS 123(R).

A summary of option activity under the plan as of June 30, 2006, and changes during the six month period then ended is presented below:

	Number of Shares	Weighted Average Price of Exercise	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
<b>Options</b>				
Outstanding at January 1, 2006	3,585,858	\$ 14.44	7.99	
Granted				
Exercised	(325,860)	7.44		
Forfeited or expired	(206,634)	18.29		
Outstanding at June 30, 2006	3,053,364	14.92	7.56	\$ 34,649
Vested and expected to vest at June 30, 2006*	2,639,773	14.56	7.40	\$ 31,086
Exercisable at June 30, 2006	1,687,171	12.43	6.75	\$ 23,630

\* These are options outstanding as of June 30, 2006 that are already vested and expected to vest in the future.

The aggregate intrinsic value in the preceding table represents the total intrinsic value, based on the Company's closing stock price of \$25.79 as of June 30, 2006.

The total intrinsic value of options exercised during the six month period ended June 30, 2006 was \$5.3 million.

**Table of Contents****SOHU.COM INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table summarizes significant ranges of outstanding and exercisable options as of June 30, 2006:

	Options Outstanding			Options Exercisable	
	as of June 30, 2006			as of June 30, 2006	
	Average	Weighted		Weighted	
	Remaining	Average		Average	
	Number	Contractual	Exercise	Number	Exercise
Range of Exercise Price	Outstanding	Life (Years)	Price	Exercisable	Price
\$0.86 - \$1.18	374,471	5.14	\$ 0.96	371,181	\$ 0.96
\$1.37 - \$1.81	39,666	6.05	1.44	34,765	1.43
\$2.27	59,000	6.31	2.27	52,402	2.27
\$3.846	70,841	3.43	3.85	70,841	3.85
\$5.875 - \$7.64	303,636	5.89	7.18	271,090	7.13
\$8.39	37,500	6.53	8.39	18,750	8.39
\$13 - \$16.84	413,082	7.88	16.15	183,608	15.9
\$17 - \$22.86	1,365,433	8.86	17.91	425,071	17.9
\$23.17 - \$34.51	389,735	7.45	28.55	259,463	29.11
	3,053,364			1,687,171	

The effects of application of SFAS 123(R) on the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2006 are summarized as follows (in thousands, except per share data):

	For the three months ended June 30, 2006	For the six months ended June 30, 2006
Decrease in net income from continuing operations	\$ 1,271	\$ 3,002
Decrease in income before income tax expense	1,271	3,002
Decrease in net income	1,271	3,002
Decrease in basic net income per share	0.04	0.08
Decrease in diluted net income per share	0.03	0.08

During the three and six months ended June 30, 2006, the adoption of SFAS 123(R) did not result in any impact on the cash flows from operating activities, investing activities and financing activities.

## Edgar Filing: SOHU COM INC - Form 10-Q

As of June 30, 2006, there was \$5.9 million of total unrecognized compensation cost related to share-based awards for which services had not been provided. That cost is expected to be recognized over a weighted average period of 1.1 years. The total fair value of options expensed during the three months ended June 30, 2006 was \$1.3 million.

There were no capitalized share-based compensation costs during the three and six months ended June 30, 2006 and 2005.

During the three and six months ended June 30, 2006, total cash received from the exercise of stock options amounted to \$1.4 million and \$2.4 million, respectively.

**Table of Contents****SOHU.COM INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Pro Forma Information under SFAS 123 for Prior Period*

The following table illustrates the effect on net income and income per share if the Company had applied the fair value recognition provisions of SFAS 123, using the Black-Scholes option pricing model, to share-based employee compensation for the three and six months ended June 30, 2005 (in thousands, except per share data):

	<b>Three Months</b>	<b>Six Months</b>
	<b>Ended June 30,</b>	<b>Ended June 30,</b>
	<b>2005</b>	<b>2005</b>
Net income as reported:	\$ 7,100	\$ 12,814
Add: Share-based compensation expense included in reported net income under APB 25		2
Deduct: Share-based compensation expense determined under fair value based method under SFAS 123	(2,113)	(2,893)
Pro forma net income	\$ 4,987	\$ 9,923
Basic net income per share:		
As reported	\$ 0.20	\$ 0.36
Pro forma	\$ 0.14	\$ 0.27
Diluted net income per share:		
As reported	\$ 0.18	\$ 0.33
Pro forma	\$ 0.13	\$ 0.26

The fair value of each option granted during the six months ended June 30, 2005 is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	<b>Six Months Ended</b>
	<b>June 30, 2005</b>
Risk-free interest rate	2.70%
Expected life (in years)	2.42
Expected dividend yield	
Volatility	92%

**7. VIEs**

## Edgar Filing: SOHU COM INC - Form 10-Q

FIN 46R Consolidation of Variable Interest Entities requires a VIE to be consolidated by a company if that company is the primary beneficiary of that VIE.

To satisfy PRC laws and regulations, the Company conducts its Internet information, wireless and certain other businesses in the PRC via its VIEs. These VIEs are directly or indirectly owned by Dr. Charles Zhang (or Dr. Zhang), the Company's Chairman, Chief Executive Officer and a major shareholder, and certain employees of the Company. Capital for the VIEs is funded by the Company through loans provided to Dr. Zhang and the employees, and is initially recorded as loans to related parties. These loans are eliminated for accounting purposes with the capital of VIEs during consolidation.

Under contractual agreements with the Company, Dr. Zhang and other Sohu employees who are shareholders of the VIEs are required to transfer their ownership in these entities to the Company, if permitted by

**Table of Contents**

**SOHU.COM INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

PRC laws and regulations, or, if not so permitted, to designees of the Company at any time to repay the loans outstanding. All voting rights of the VIEs are assigned to the Company, and the Company has the right to designate all directors and senior management personnel of the VIEs. Dr. Zhang and the other Sohu employees who are shareholders of the VIEs have pledged their shares in the VIEs as collateral for the loans. As of June 30, 2006, the amount aggregate of these loans was \$9.8 million.

The following is a summary of the VIEs of the Company:

a) Beijing Sohu

Beijing Sohu Online Network Information Services, Ltd (or Beijing Sohu) was incorporated in the PRC in 1998 and engages in Internet information and wireless services in the PRC on behalf of the Company. The registered capital of Beijing Sohu is \$242,000. Originally, Dr. Zhang and He Jinmei held 80% and 20% interests in Beijing Sohu, respectively. He Jinmei transferred all of her shares in Beijing Sohu to High Century in June 2005. As a result, Dr. Zhang and High Century hold 80% and 20% interests in Beijing Sohu, respectively.

b) High Century

Beijing Century High Tech Investment Co., Ltd. (or High Century) was incorporated in the PRC in 2001 and engages in investment holding in the PRC on behalf of the Company. The registered capital of High Century is \$4,595,000. Dr. Zhang and Li Wei, an employee of the Company, hold 80% and 20% interests in High Century, respectively.

c) Sohu Entertainment

Beijing Sohu Entertainment Culture Media Co., Ltd. (or Sohu Entertainment), formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd (or Hengda) was incorporated in the PRC in 2002 and engages in Internet access and wireless services in the PRC on behalf of the Company. The registered capital of Sohu Entertainment is \$1,210,000. Originally, High Century and Li Wei held 80% and 20% interests in Sohu Entertainment, respectively. In November 2004, to further satisfy PRC regulations, High Century and Li Wei transferred their interests in Sohu Entertainment to Wang Xin and Wang Jianjun, each of whom is an employee of the Company. As a result, Wang Xin and Wang Jianjun hold 80% and 20% interests in Sohu Entertainment, respectively.

d) Sohu Internet

Beijing Sohu Internet Information Service Co. Ltd. (or Sohu Internet) was incorporated in the PRC in 2003 and engages in Internet information, wireless and advertising services in the PRC on behalf of the Company. The original registered capital was \$605,000, and High Century and He Jinmei held 80% and 20% interests in Sohu Internet, respectively. In December 2003, Sohu Entertainment made a \$605,000 investment in Sohu Internet. In April 2005, He Jinmei transferred all her interests in Sohu Internet to High Century, and High Century made a \$1,208,000 additional investment in Sohu Internet. As a result, the registered capital is now \$2,418,000, with High Century and Sohu Entertainment holding 75% and 25% interests, respectively.

e) Goodfeel

Beijing Goodfeel Information Technology Co., Ltd. (or Goodfeel) was incorporated in the PRC in 2001 and engages in value-added telecommunication services in the PRC. The registered capital of Goodfeel is

**Table of Contents**

**SOHU.COM INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

\$1,208,000. In May 2004, High Century and Sohu Internet acquired 73% and 27% interests in Goodfeel, respectively. In July 2004, High Century and Sohu Internet invested \$613,000 and \$473,000 in Goodfeel, respectively, so that High Century owned a 58.1% interest in Goodfeel with the remaining 41.9% interest owned by Sohu Internet. In October 2004, to further satisfy PRC regulations, High Century and Sohu Internet transferred their interests in Goodfeel to Deng Xiufeng and Zhou Jing, each of whom is an employee of the Company. As a result, Deng Xiufeng and Zhou Jing own 58.1% and 41.9% interests in Goodfeel, respectively.

f) Huohu

Beijing Huohu Digital Technology Co., Ltd. (or Huohu) was incorporated in the PRC in 2005. Huohu engages in software and technology development for the games business. The registered capital of Huohu is \$121,000. Beijing Sohu New Era Information Technology Co., Ltd. (or Sohu Era), one of the indirect China-based subsidiaries of the Company, and an employee of Huohu, hold 75% and 25% interests in Huohu, respectively. The Company provided the employee with a non-interest bearing loan of \$31,000 to finance his capital contribution to Huohu. The loan is repayable upon demand by the Company at any time or upon termination of the employment of the employee and can only be repaid through transfer of the employee's shares in Huohu to Sohu Era. Based on the arrangement between Sohu Era and the employee, Sohu Era is the sole and primary beneficiary of Houhu. Accordingly, Huohu is 100% consolidated into the financial statements of the Company.

g) Tu Xing Tian Xia

Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (or Tu Xing Tian Xia) was incorporated in the PRC in 1999 and engages in mapping services in the PRC. The registered capital of Tu Xing Tian Xia is \$248,000. In May 2005, in connection with the Company's acquisition of Go2Map, the Company designated High Century and Sohu Internet as its designees to purchase the outstanding registered capital of Tu Xing Tian Xia. As a result, High Century and Sohu Internet own 56.1% and 43.9% interests in Tu Xing Tian Xia, respectively.

h) Feng Yang Tian Lang

Beijing Feng Yang Tian Lang Advertising Co., Ltd. (or Feng Yang Tian Lang) was incorporated in the PRC in 2005 and engages in advertising services in the PRC. The registered capital of Feng Yang Tian Lang is \$248,000. Sohu Internet and High Century each holds a 50% interest in Feng Yang Tian Lang.

i) Sogou Information

Beijing Sogou Information Services Co., Ltd. (or Sogou Information) was incorporated in the PRC in 2005 and engages in providing Internet information services in the PRC. The registered capital of Sogou Information is \$2,480,000. Zhou Jing and Li Wei, each of whom is an employee of the Company, each owns a 50% interest in Sogou Information.

Pursuant to FIN 46R, Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and Sogou Information are VIEs, of which the Company is the primary beneficiary. Accordingly, the VIEs have been consolidated in the Company's financial statements.

As of June 30, 2006, the above VIEs have aggregate accumulated net profits of approximately \$4.4 million which have been reflected in the consolidated financial statements.



**Table of Contents****SOHU.COM INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****8. RELATED PARTY TRANSACTIONS**

The following table summarizes related party transactions during the three and six months ended June 30, 2006 and 2005, respectively (in thousands):

Name or Description of Related Party	Description of Transactions	Accounting Captions	Three Months Ended		Six Months Ended	
			June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Qingfan, a company controlled by Dr Zhang's brother	Delivery service provided by Qingfan	Cost of revenues	\$ 9	\$ 33	\$ 27	\$ 64
An investee of the Company	Amortization of licensing fee	Product development expenses	26	25	52	50
	Revenue sharing	Cost of revenues	435	296	881	580

**9. COMMITMENTS AND CONTINGENCIES**

The Company's China-based subsidiaries and VIEs, Sohu Era, Sohu Internet, Beijing Sogou Technology Development Co., Ltd. (or Sogou Technology) and Sogou Information enjoy tax benefits which are available to new technology enterprises. The effective income tax rate for new technology enterprises registered and operating in Beijing Zhongguancun Science Park is 15%, while the local income tax will be exempted as long as the enterprise holds the status of a new technology enterprise. New technology enterprises are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction, at the rate of 7.5%, for the subsequent three years. Sohu Era and Sohu Internet were incorporated in 2003 and, providing there is no change in their status as a new technology enterprise or a change in the relevant regulations, are subject to an income tax rate of 0% in 2003 to 2005, 7.5% in 2006 to 2008 and 15% thereafter. Sogou Information was incorporated in 2005 and Sogou Technology was incorporated in 2006 and, providing there is no change in their status as a new technology enterprise or a change in the relevant regulations, are subject to an income tax rate of 0% in 2006 to 2008, 7.5% in 2009 to 2011 and 15% thereafter. To be considered a new technology enterprise under current PRC law, a company must: (i) operate in the high-tech industry (which includes the information technology industry); (ii) be incorporated and operate in Beijing Zhongguancun Science Park; (iii) receive 60% of its revenue from high-tech products or services; and (iv) have at least 20% of its employees involved in technology development. New technology enterprises are subject to annual inspection to determine whether they continue to meet these requirements. If Sohu Era, Sohu Internet, Sogou Technology and Sogou Information did not meet the requirements of a new technology enterprise, they could be subject to enterprise income tax in China at rates up to 33%, which could cause a significant reduction in the Company's after-tax income.

The Chinese market in which the Company operates poses certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability of the Company to operate an Internet business, and to conduct brand advertising, sponsored search, wireless and online game services in the PRC. Though the PRC has, since 1978, implemented a wide range of market-oriented economic reforms, continued reforms and progress towards a full market-oriented economy are uncertain. In addition, the telecommunication, information, and media industries remain highly regulated. Restrictions are currently in place or are unclear with respect to which segments of these industries foreign owned entities, like the Company, may operate. The Chinese government may issue from time to time new laws or new interpretations on existing laws to regulate areas such as telecommunication, information and media. Regulatory risks also encompass the interpretation by the tax authorities of current tax laws and regulations, including the applicability of certain preferential tax treatments.

**Table of Contents**

**SOHU.COM INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

The Company's legal structure and scope of operations in China could be subjected to restrictions which could result in severe limits to the Company's ability to conduct business in the PRC.

The Company's sales, purchase and expense transactions are generally denominated in Renminbi (or RMB) and a significant portion of the Company's assets and liabilities are denominated in RMB. The RMB is not freely convertible into foreign currencies. In China, foreign exchange transactions are required by law to be transacted only by authorized financial institutions. Remittances in currencies other than RMB by the Company's subsidiaries in China may require certain supporting documentation in order to effect the remittance.

The Company had entered in certain sponsorship agreements, under which the Company is obliged to provide advertising services and Website construction, operation and maintenance services to third parties during the contract periods.

During the six months ended June 30, 2006, Sohu Internet entered into an agreement and committed to invest \$1.2 million in a newly established China-based investment holding company. The registered capital of the investee is \$62 million. After the investment, Sohu Internet will hold 2% of equity interests in the investee.

**10. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. This Interpretation is effective as of January 1, 2007. The Company is currently evaluating the impact of FIN 48 on its financial statements.

**11. SUBSEQUENT EVENTS**

In October 2005, the board of directors approved the Company's repurchase of outstanding shares of its common stock from the open market, on an opportunistic basis, up to \$15 million. As of August 1, 2006, the Company had repurchased a total of 690,581 shares, fully utilizing the \$15 million available under this initial program. On July 25, 2006, the board of directors approved an additional \$15 million stock repurchase program.

In July 2006, the Company granted approximately 420,000 restricted stock units to its employees and directors under the 2000 Stock Incentive Plan.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*As used in this report, references to us, we, our, our company, Sohu and Sohu.com are to Sohu.com Inc. and, except where the context requires otherwise, our subsidiaries, Sohu.com (Hong Kong) Limited (or Sohu Hong Kong), Sohu.com Limited, Kylie Enterprises Limited, All Honest International Limited, Marvel Hero Limited, Go2Map Inc., Sohu.com (Search) Limited, Sogou Inc., Sogou (BVI) Limited, Sohu ITC Information Technology (Beijing) Co., Ltd. (or Beijing ITC), Beijing Sohu New Era Information Technology Co., Ltd. (or Sohu Era), Beijing Sohu Interactive Software Co., Ltd. (or Sohu Software), Go2Map Software (Beijing) Co., Ltd. (or Go2Map Software), Beijing Sogou Technology Development Co., Ltd. (or Sogou Technology), Beijing Sohu New Media Information Technology Co., Ltd. (or Sohu New Media) and our VIEs Beijing Sohu Online Network Information Services, Ltd. (or Beijing Sohu), Beijing Century High Tech Investment Co., Ltd. (or High Century), Beijing Sohu Entertainment Culture Media Co., Ltd. (or Sohu Entertainment, formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd. or Hengda), Beijing Sohu Internet Information Service Co., Ltd. (or Sohu Internet), Beijing Goodfeel Information Technology Co., Ltd. (or Goodfeel), Beijing Huohu Digital Technology Co., Ltd. (or Huohu), Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (or Tu Xing Tian Xia), Beijing Feng Yang Tian Lang Advertising Co., Ltd. (or Feng Yang Tian Lang), and Beijing Sogou Information Services Co., Ltd. (or Sogou Information) and these references should be interpreted accordingly. Unless otherwise specified, references to China or PRC refer to the People's Republic of China and do not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan. 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, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words expect, anticipate, intend, believe, or similar language. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our business and financial performance are subject to substantial risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information set forth below under the caption Risk Factors. Readers are cautioned not to place undue reliance on these forward-looking statements.*

**OVERVIEW**

We are a leading online media, search and mobile value-added services company providing comprehensive online products and services to consumers and businesses in China, through our comprehensive matrices of web properties, consisting of the mass portal and leading online media destination www.sohu.com; interactive search engine www.sogou.com; the leading online alumni club www.chinaren.com; the leading games information portal www.17173.com; one of the top real estate Websites www.focus.cn; the wireless value-added services provider www.goodfeel.com.cn; and a leading online mapping service Website www.go2map.com. We offer our user community very broad choices regarding information, entertainment, communication and wireless. We derive revenues primarily through the sale of brand advertising, sponsored search, wireless and online game services. We also sponsor major events to further enhance our viewership and create a positive branding impact.

We were incorporated in the state of Delaware in August 1996 as Internet Technologies China Incorporated, and launched our original Website, itc.com.cn, in January 1997. During 1997, we developed the Sohu online directory, search engine and related technology infrastructure, and also focused on recruiting personnel, raising capital and aggregating content to attract and retain users. In February 1998, we re-launched our Website under the domain name sohu.com. In September 1999, we re-named our company Sohu.com Inc. Our business operations are conducted primarily through our indirect wholly owned subsidiaries, Beijing ITC, Sohu Era, Sohu Software, Go2Map Software, Sogou Technology and Sohu New Media and our VIEs, Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and Sogou Information.

---

**Table of Contents**

**CRITICAL ACCOUNTING POLICIES AND MANAGEMENT ESTIMATES**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe accounting for brand advertising and sponsored search revenues, accounting for wireless revenues and cost of revenues, gross versus net basis of revenue recognition, determination of functional currencies, allowance for doubtful accounts, valuation allowance against deferred tax assets, assessment of impairment for goodwill and other intangible assets and determination of share-based compensation expense represent critical accounting policies that reflect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

***Revenue Recognition***

***Advertising Revenues***

Advertising revenues include revenue from brand advertising and sponsored search services, after deducting agent rebates and applicable business tax. No revenues from advertising-for-advertising barter transactions were recognized.

Brand advertising contracts establish the fixed price and advertising services to be provided. Pursuant to brand advertising contracts, we provide advertisement placements on various Website channels and in different formats, including but not limited to banners, links, logos, buttons, rich media, content integration and email marketing. Revenue is recognized ratably over the period the advertising is provided and, as such, we consider the services to have been delivered. We treat all elements of advertising contracts as a single unit of accounting for revenue recognition purposes. Based upon our credit assessments of our customers prior to entering into contracts, we determine if collectibility is reasonably assured. In situations where collectibility is not deemed to be reasonably assured, we recognize revenue upon payment from the customer.

Sponsorship contracts may include services similar to those in our advertising contracts, are generally for larger dollar amounts and for a longer period of time, may allow advertisers to sponsor a particular area on our Websites, may include brand affiliation services and/or a larger volume of services, and may require some exclusivity or premiere placements. Sponsorship advertisement revenues are normally recognized on a straight-line basis over the contract period, provided we are meeting our obligations under the contract.

Pursuant to sponsored search contracts, which are normally for relatively small dollar amounts and are with small and medium size enterprises, sponsored search services mainly include priority placements in our search directory, listing in our classified advertisements section and pay-for-click services consisting of displaying the text-based links of our advertisers on our Websites and our Website Alliance network. We normally provide the priority placements services and listing in our classified advertisements section for a fixed fee over the service period of the contracts. Revenues on priority placements and listing in our classified advertisements section are normally recognized on a straight-line basis over the contract period provided we are meeting our obligation under the contract. Pay-for-click services of displaying the text-based links to our advertisers Websites are charged on a cost per click basis, so that an advertiser pays us only when a user clicks on the displayed link. The priority of the display of text-based links is based on the bidding price of different advertisers. Revenues from the pay-for-click services are recognized as the users click on the links.

Material differences could result in the amount and timing of our advertising revenue for any period if management made different judgments or utilized different estimates.

**Table of Contents**

*Non-Advertising Revenues*

Non-advertising revenues include revenues principally from wireless and online game services.

Wireless revenues are derived from providing short messaging services (or SMS), Wireless Application Protocol (or WAP), multi-media messaging services (or MMS), Ring Back Tone (or RBT), and interactive voice response (or IVR), mainly consisting of news, weather forecast, chatting, entertainment information, ring tones and logo downloads and various other mobile related products provided to mobile phone users. Wireless service fees are charged on a monthly or per message/download basis. Wireless revenues and cost of revenues are recognized in the month in which the service is performed, provided no significant Sohu obligations remain. We rely on mobile network operators in China to bill mobile phone users for wireless service fees. In order to meet ownership requirements under PRC law which restrict or prohibit w