

Google Inc.
Form 10-Q
May 10, 2006
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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, 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: 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)

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(Address of principal executive offices)

(Zip Code)

(650) 253-4000

(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, 2006, the number of shares outstanding of Google's Class A common stock was 214,947,093 shares and the number of shares outstanding of Google's Class B common stock was 88,138,358 shares.

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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,	As of March 31,
	2005	2006 (unaudited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,877,174	\$ 2,935,179
Marketable securities	4,157,073	5,493,849
Accounts receivable, net of allowance of \$14,852 and \$15,604	687,976	844,378
Deferred income taxes, net	49,341	26,317
Prepaid revenue share, expenses and other assets	229,507	256,234
Total current assets	9,001,071	9,555,957
Property and equipment, net	961,749	1,209,681
Goodwill	194,900	318,806
Intangible assets, net	82,783	160,573
Prepaid revenue share, expenses and other assets, non-current	31,310	49,853
Total assets	\$ 10,271,813	\$ 11,294,870
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 115,575	\$ 145,911
Accrued compensation and benefits	198,788	118,395
Accrued expenses and other current liabilities	114,377	156,784
Accrued revenue share	215,771	267,202
Deferred revenue	73,099	80,172
Income taxes payable	27,774	211,560
Total current liabilities	745,384	980,024
Deferred revenue, long-term	10,468	17,123
Liability for stock options exercised early, long-term	2,083	1,368
Deferred income taxes, net	35,419	
Other long-term liabilities	59,502	53,087
Stockholders' equity:		
Common stock, \$0.001 par value: 9,000,000 shares authorized and 293,027 and 295,063 shares issued and outstanding, excluding 3,303 and 2,390 shares subject to repurchase at December 31, 2005 and March 31, 2006	293	295
Additional paid-in capital	7,477,792	7,605,177
Deferred stock-based compensation	(119,015)	
Accumulated other comprehensive income (loss)	4,019	(10,363)
Retained earnings	2,055,868	2,648,159

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Total stockholders' equity	9,418,957	10,243,268
Total liabilities and stockholders' equity	\$ 10,271,813	\$ 11,294,870

See accompanying notes.

Table of Contents**GOOGLE INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(in thousands, except per share amounts)

	Three Months Ended March 31,	
	2005	2006
	(unaudited)	
Revenues	\$ 1,256,516	\$ 2,253,755
Costs and expenses:		
Cost of revenues (including stock-based compensation expense of \$1,573 and \$2,283)(1)	546,781	904,119
Research and development (including stock-based compensation expense of \$29,299 and \$73,086) (1)	108,711	246,599
Sales and marketing (including stock-based compensation expense of \$6,536 and \$15,929) (1)	89,488	190,943
General and administrative (including stock-based compensation expense of \$11,500 and \$23,366) (1)	68,766	169,395
Total costs and expenses	813,746	1,511,056
Income from operations	442,770	742,699
Interest income and other, net	13,686	67,919
Income before income taxes	456,456	810,618
Provision for income taxes	87,263	218,327
Net income	\$ 369,193	\$ 592,291
Net income per share:		
Basic	\$ 1.39	\$ 2.02
Diluted	\$ 1.29	\$ 1.95
Number of shares used in per share calculations:		
Basic	266,106	293,896
Diluted	286,612	304,123

- (1) Stock-based compensation recognized in the three months ended March 31, 2005, accounted for under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, has been reclassified to these expense lines to conform with the presentation in the three months ended March 31, 2006. As discussed in Note 1 of the accompanying notes, stock-based compensation for the three months ended March 31, 2006, is presented in conformity with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*.

See accompanying notes.

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

(in thousands)

	Three Months Ended March 31,	
	2005	2006
	(unaudited)	
Operating activities		
Net income	\$ 369,193	\$ 592,291
Adjustments:		
Depreciation of property and equipment	46,478	95,868
Amortization of intangibles and warrants	9,715	15,290
In-process research and development		4,000
Stock-based compensation	48,908	114,664
Excess tax benefits from stock-based award activity	77,377	
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(60,069)	(155,221)
Income taxes, net	6,044	139,242
Prepaid revenue share, expenses and other assets	(29,571)	(26,525)
Accounts payable	42,694	30,232
Accrued expenses and other liabilities	(17,767)	(39,295)
Accrued revenue share	32,085	51,216
Deferred revenue	4,535	3,042
Net cash provided by operating activities	529,622	824,804
Investing activities		
Purchases of property and equipment	(142,391)	(344,938)
Purchases of marketable securities	(1,160,160)	(13,111,471)
Maturities and sales of marketable securities	835,223	11,755,756
Acquisitions, net of cash acquired, and purchases of intangible and other assets	(5,000)	(187,964)
Net cash used in investing activities	(472,328)	(1,888,617)
Financing activities		
Proceeds from exercise of stock options, net	4,097	42,611
Excess tax benefits from stock-based award activity		77,285
Payments of principal on capital leases and equipment loans	(592)	
Net cash provided by financing activities	3,505	119,896
Effect of exchange rate changes on cash and cash equivalents	(5,100)	1,922
Net increase (decrease) in cash and cash equivalents	55,699	(941,995)
Cash and cash equivalents at beginning of year	426,873	3,877,174
Cash and cash equivalents at end of period	\$ 482,572	\$ 2,935,179
Supplemental disclosures of cash flow information		
Cash paid for interest	\$ 93	\$ 8

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Cash paid for income taxes	\$	396	\$	1,126
Acquisition related activities:				
Issuance of equity in connection with acquisitions, net of deferred stock-based compensation	\$	2,011	\$	

See accompanying notes.

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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, 2006, the condensed consolidated statements of income for the three months ended March 31, 2005 and 2006, and the condensed consolidated statements of cash flows for the three months ended March 31, 2005 and 2006 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, 2006, our results of operations for the three months ended March 31, 2005 and 2006, and our cash flows for the three months ended March 31, 2005 and 2006. The results of operations for the three months ended March 31, 2006 are not necessarily indicative of the results to be expected for the year ending December 31, 2006.

These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our 2005 Annual Report on Form 10-K filed on March 16, 2006.

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 and sales allowances, fair values of marketable securities and investments, fair values of acquired 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.

Table of Contents**GOOGLE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Revenue Recognition**

The following table presents our revenues (in thousands):

	Three Months Ended March 31,	
	2005	2006
	(Unaudited)	
Advertising revenues:		
Google web sites	\$ 656,997	\$ 1,297,317
Google Network web sites	584,115	928,376
 Total advertising revenues	 1,241,112	 2,225,693
Licensing and other revenues	15,404	28,062
 Revenues	 \$ 1,256,516	 \$ 2,253,755

In the first quarter of 2000, we introduced our first advertising program through which we offered advertisers the ability to place text-based ads on Google web sites targeted to users' search queries. Advertisers paid us based on the number of times their ads were displayed on users' search results pages and we recognized revenue at the time these ads appeared. In the fourth quarter of 2000, we launched Google AdWords, an online self-service program that enables advertisers to place text-based ads on Google web sites. AdWords is also available through our direct sales force. AdWords advertisers 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 exclusively on a cost-per-click basis, so that an advertiser pays us only when a user clicks on one of its ads. We recognize as revenue the fees charged advertisers each time a user clicks on one of the text-based ads that are displayed next to the search results on Google web sites. From January 1, 2004 until the end of the first quarter of 2005, the AdWords cost-per-click pricing structure was the only structure available to our advertisers. However, during the second quarter of 2005, we launched an AdWords program that enables advertisers to pay us based on the number of times their ads appear on Google Network member sites specified by the advertiser. We recognize as revenue the fees charged advertisers each time their ads are displayed on the Google Network member sites.

In the third quarter of 2005, we launched the Google Publication Ads Program through which we distribute our advertisers' ads for publication in magazines. We recognize as revenue the fees charged advertisers when 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. dMarc, now one of our wholly-owned subsidiaries, distributes our advertisers' ads for broadcast by radio stations. 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.

Google AdSense is the program through which we distribute our advertisers' ads for display on the web sites of our Google Network members. In accordance with Emerging Issues Task Force (EITF) Issue No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent* (EITF 99-19), we recognize as revenues the fees charged advertisers each time a user clicks on one of the text-based ads that are displayed next to the search results or on the content pages of our Google Network members' web sites and, for those advertisers who use our cost-per impression pricing, the fees charged advertisers each time an ad is displayed on our members' sites. Finally, we recognize as revenues the fees charged advertisers for ads published in the magazines or broadcasted by the radio stations of our Google Network members. These revenues are reported on a gross basis primarily because we are the primary obligor to our advertisers.

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GOOGLE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We generate fees from search services through a variety of contractual arrangements, which include per-query search fees and search service hosting fees. Revenues from set-up and support fees and search service hosting fees are recognized on a straight-line basis over the term of the contract, which is the expected period during which these services will be provided. Our policy is to recognize revenues from per-query search fees in the period queries are made and results are delivered.

We provide search services pursuant to certain AdSense agreements. We believe that search services and revenue share arrangements represent separate units of accounting pursuant to EITF 00-21 *Revenue Arrangements with Multiple Deliverables*. These separate services are provided simultaneously to the Google Network member and are recognized as revenues in the periods provided.

In the first quarter of 2006, we launched Google Video through which we make video 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, we recognize as revenues the fees we receive from end users net of the amounts we pay to our video content providers in accordance with EITF 99-19.

We also generate fees from the sale and license of our Search Appliance, which includes hardware, software and 12 to 24 months of post-contract support. We recognize revenue in accordance with Statement of Position 97-2, *Software Revenue Recognition*, as amended. For transactions in which the elements are not sold separately, sufficient vendor-specific objective evidence does not exist for the allocation of revenue. As a result, the entire fee is recognized ratably over the term of the post-contract support arrangement.

Deferred revenue is recorded when payments are received in advance of our performance in the underlying agreement on the accompanying condensed consolidated balance sheets.

Cost of Revenues

Cost of revenues consists primarily of traffic acquisition costs. Traffic acquisition costs consist of amounts ultimately paid to Google Network members, as well as to partners who direct search queries to our web site. These amounts are primarily based on revenue share arrangements under which we pay our Google Network members and other partners a portion of the fees we receive from our advertisers. 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. Traffic acquisition costs were \$461.8 million and \$722.7 million in the three months ended March 31, 2005 and 2006.

In addition, cost of revenues includes the expenses associated with the operation of our data centers, including depreciation, labor, energy and bandwidth costs, as well as credit card and other transaction fees related to processing customer transactions.

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GOOGLE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock-based Compensation

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R) that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123R eliminates the ability to account for share-based compensation transactions using the intrinsic value method under Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*, and generally requires instead that such transactions be accounted for using a fair-value-based method. We adopted SFAS 123R beginning January 1, 2006.

SFAS 123R requires the use of a valuation model to calculate the fair value of stock-based awards. We have elected to use the Black-Scholes-Merton (BSM) option-pricing model to determine the fair value of stock-based awards on the dates of grant, consistent with that used for pro forma disclosures under SFAS No. 123, *Accounting for Stock-Based Compensation*. Restricted Stock Units (RSUs) are measured based on the fair market values of the underlying stock on the dates of grant. Shares are issued on the dates of vest net of the statutory withholding requirements to be paid by us on behalf of our employees. As a result, the actual number of shares issued will be less than the actual number of RSUs outstanding. Furthermore, in accordance with SFAS 123R, the liability for withholding amounts to be paid by us will be recorded as a reduction to additional paid-in capital when paid.

We have elected the modified prospective transition method as permitted by SFAS 123R and accordingly prior periods have not been restated to reflect the impact of SFAS 123R. Under this method, we are required to recognize stock-based compensation for all new and unvested stock-based awards that are ultimately expected to vest as the requisite service is rendered beginning January 1, 2006. Stock-based compensation is measured based on the fair values of all stock-based awards on the dates of grant.

We will recognize stock-based compensation using the straight-line method for all stock awards issued after January 1, 2006. For stock awards issued prior to January 1, 2006, we continue to recognize stock-based compensation using the accelerated method, other than RSUs issued to new employees that vest based on the employee's performance for which we use the straight-line method in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.

SFAS 123R requires that the deferred stock-based compensation on our balance sheet on the date of adoption be netted against additional paid-in capital. At December 31, 2005, we had \$119.0 million of deferred stock-based compensation which was netted against additional paid-in capital on January 1, 2006, as reflected in the accompanying Condensed Consolidated Balance Sheet at March 31, 2006.

Also, in accordance with SFAS 123R, beginning in the first quarter of 2006 we have presented the benefits of tax deductions in excess of recognized compensation expense as a cash flow from financing activities in the accompanying Condensed Consolidated Statement of Cash Flows, rather than as a cash flow from operating activities, as was prescribed under accounting rules applicable through December 31, 2005. This requirement reduces and increases the amounts we record as net cash provided by operating activities and net cash provided by financing activities, respectively. Total cash flow remains unchanged from what would have been reported under prior accounting rules.

In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB No. 107). In accordance with this Bulletin, beginning in the first quarter of 2006, we no longer present stock-based compensation separately on our statements of income. Instead we present stock-based compensation in the

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same lines as cash compensation paid to the same individuals. Stock-based compensation in the first quarter of 2005 has been reclassified to conform to the presentation in the first quarter of 2006.

We account for stock awards issued to non-employees in accordance with the provisions of SFAS 123R and EITF 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* (EITF 96-18). Under SFAS 123R and EITF 96-18, we use the BSM method to measure the value of options granted to non-employees at each vesting date to determine the appropriate charge to stock-based compensation.

Prior to the adoption of SFAS 123R, we accounted for our employee stock-based compensation using the intrinsic value method prescribed by APB 25. We applied below the disclosure provisions of SFAS 123, as amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* as if the fair value method had been applied. If this method had been used, our net income and net income per share for the three months ended March 31, 2005 would have been adjusted to the pro forma amounts below (in thousands except per share data):

	Three Months Ended March 31, 2005 (unaudited)
Net income, as reported	\$ 369,193
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	29,322
Deduct: Total stock-based employee compensation expense under the fair value based method for all awards, net of related tax effects	(46,280)
Net income, pro forma	\$ 352,235
Net income per share:	
As reported for prior period basic	\$ 1.39
Pro forma basic	\$ 1.32
As reported for prior period diluted	\$ 1.29
Pro forma diluted	\$ 1.23

In the three months ended March 31, 2006, we recognized stock-based compensation and related tax benefits of \$114.7 million and \$27.4 million respectively.

As a result of adopting SFAS 123R, our income before income taxes and net income for the quarter ended March 31, 2006, were \$61.4 million and \$46.7 million less than if we had continued to account for share-based compensation under APB 25. Furthermore, basic and diluted earnings per share for the quarter ended March 31, 2006 would have been \$2.17 and \$2.10 if we had not adopted SFAS 123R, compared to reported basic and diluted earnings per share of \$2.02 and \$1.95.

Net Income per Share

We compute net income per share in accordance with SFAS 128, *Earnings per Share*. Under the provisions of SFAS 128, basic net income per share is computed using the weighted average number of common shares outstanding during the period except that it does not include unvested common shares subject to repurchase or cancellation. Diluted net income per share is computed using the weighted average number of common shares and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options, restricted shares, restricted stock units and unvested common shares subject to repurchase or cancellation. The dilutive effect of outstanding stock

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options, restricted shares and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method.

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

	Three Months Ended March 31,	
	2005	2006
	(unaudited)	
Basic and diluted net income per share:		
Numerator:		
Net income	\$ 369,193	\$ 592,291
Denominator:		
Weighted average common shares outstanding	275,816	296,957
Less: Weighted average unvested common shares subject to repurchase or cancellation	(9,710)	(3,061)
Denominator for basic calculation	266,106	293,896
Effect of dilutive securities:		
Add:		
Weighted average stock options, restricted shares, restricted stock units and unvested common shares subject to repurchase or cancellation	20,506	10,227
Denominator for diluted calculation	286,612	304,123
Net income per share, basic	\$ 1.39	\$ 2.02
Net income per share, diluted	\$ 1.29	\$ 1.95

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally two to five years. Buildings are depreciated over periods up to 25 years. Equipment under capital leases and leasehold improvements are amortized over the shorter of the lease term or the estimated useful lives of the assets. Construction in process is primarily related to the building of production equipment servers and leasehold improvements. Depreciation for these assets commences once they are placed in service.

Cash and Cash Equivalents and Marketable Securities

We invest our excess cash in money market funds and in highly liquid debt instruments of U.S. municipalities, corporations and the U.S. government and its agencies. All highly liquid investments with stated maturities of three months or less from date of purchase are classified as cash equivalents; all highly liquid investments with stated maturities of greater than three months are classified as marketable securities.

We determine the appropriate classification of our investments in marketable debt and equity securities at the time of purchase and reevaluate such designation at each balance sheet date. Our marketable debt and equity securities have been classified and accounted for as available for sale. We may or may not hold securities with stated maturities greater than twelve months until maturity. In response to changes in the availability of and the

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yield on alternative investments as well as liquidity requirements, we occasionally sell these securities prior to their stated maturities. As these debt and equity securities are viewed by us as available to support current operations, based on the provisions of Accounting Research Bulletin No. 43, Chapter 3A, Working Capital-Current Assets and Liabilities, equity securities, as well as debt securities with maturities beyond 12 months (such as our auction rate securities) are classified as current assets in the accompanying Condensed Consolidated Balance Sheets. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity, except for unrealized losses determined to be other than temporary which are recorded as interest income and other, net, in accordance with our policy and FASB Staff Position (FSP) Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of interest income and other, net.

Derivative Financial Instruments

We enter into forward foreign exchange contracts with financial institutions to reduce the risk that our cash flows and earnings will be adversely affected by foreign currency exchange rate fluctuations. This program is not designed for trading or speculative purposes.

In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, we recognize derivative instruments as either assets or liabilities on the balance sheet at fair value. These forward exchange contracts are not accounted for as hedges and, therefore, changes in the fair value of these instruments are recorded as interest income and other, net. Neither the cost nor the fair value of these forward foreign exchange contracts was material at March 31, 2006. The notional principal of forward foreign exchange contracts to purchase U.S. dollars with foreign currencies was \$477.0 and \$629.5 million at December 31, 2005 and March 31, 2006, respectively. There were no other forward foreign exchange contracts outstanding at December 31, 2005 or March 31, 2006.

Note 2. Cash, Cash Equivalents and Marketable Securities

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

	As of December 31, 2005	As of March 31, 2006
	(unaudited)	
Cash and cash equivalents:		
Cash	\$ 1,588,515	\$ 2,002,399
Cash equivalents:		
U.S. government notes and agencies	2,281,858	915,782
Money market mutual funds	6,801	16,998
 Total cash and cash equivalents	 3,877,174	 2,935,179
Marketable securities:		
Municipal securities	1,203,209	700,965
U.S. government notes and agencies	2,906,698	4,750,852
Equity security	47,166	42,032
 Total marketable securities	 4,157,073	 5,493,849
 Total cash, cash equivalents and marketable securities	 \$ 8,034,247	 \$ 8,429,028

Table of Contents**GOOGLE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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, 2005		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Municipal securities	\$ 1,219,078	\$ 28	\$ (15,897)	\$ 1,203,209
U.S. government notes and agencies	2,911,410	418	(5,130)	2,906,698
Equity security	5,000	42,166		47,166
Total marketable securities	\$ 4,135,488	\$ 42,612	\$ (21,027)	\$ 4,157,073

	Adjusted Cost	As of March 31, 2006 (unaudited)		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Municipal securities	\$ 712,284	\$ 30	\$ (11,349)	\$ 700,965
U.S. government notes and agencies	4,773,944	7	(23,099)	4,750,852
Equity security	5,000	37,032		42,032
Total marketable securities	\$ 5,491,228	\$ 37,069	\$ (34,448)	\$ 5,493,849

Gross unrealized gains and losses on cash equivalents were not material at December 31, 2005 and March 31, 2006. We found no other-than-temporary impairments to our marketable securities in the three months ended March 31, 2006 and March 31, 2005. We incurred \$7.6 million and \$4.6 million of realized losses on our investments in the three months ended March 31, 2006 and March 31, 2005.

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, 2005	March 31, 2006 (Unaudited)
Due within 1 year	\$ 970,073	\$ 1,992,339
Due after 1 year through 5 years	2,967,148	3,390,137
Due after 5 years through 10 years	59,122	18,350
Due after 10 years	160,730	93,023
Total marketable securities	\$ 4,157,073	\$ 5,493,849

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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, 2005 and March 31, 2006, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in thousands):

Security Description	Less than 12 Months		As of December 31, 2005 12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government notes and agencies	\$ 2,099,408	\$ (5,130)	\$	\$	\$ 2,099,408	\$ (5,130)
Municipal securities	607,990	(7,705)	513,425	(8,192)	1,121,415	(15,897)
Total	\$ 2,707,398	\$ (12,835)	\$ 513,425	\$ (8,192)	\$ 3,220,823	\$ (21,027)

Security Description	Less than 12 Months		As of March 31, 2006 12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government notes and agencies	\$ 4,542,391	\$ (23,099)	\$	\$	\$ 4,542,391	\$ (23,099)
Municipal securities	224,230	(3,375)	435,030	(7,974)	659,260	(11,349)
Total	\$ 4,766,621	\$ (26,474)	\$ 435,030	\$ (7,974)	\$ 5,201,651	\$ (34,448)

Note 3. Property and Equipment

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

	As of December 31, 2005	As of March 31, 2006 (unaudited)
Information technology assets	\$ 949,758	\$ 1,061,797
Construction in process	211,088	349,462
Land and buildings	124,752	165,934
Leasehold improvements	115,108	153,870
Furniture and fixtures	16,719	18,505
Total	1,417,425	1,749,568
Less accumulated depreciation and amortization	455,676	539,887
Property and equipment, net	\$ 961,749	\$ 1,209,681

Note 4. Acquisitions

During the three months ended March 31, 2006, we acquired all of the voting interests of dMarc Broadcasting, Inc. (dMarc), a digital solutions provider for the radio broadcast industry. This transaction was accounted for as a business combination. The total purchase price was \$97.6 million which primarily consisted of cash payments of \$94.4 million. In addition, we are obligated to make additional cash payments of up to \$1.136 billion if certain product integration, net revenue and advertising inventory targets are met through

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December 2008. Since these contingent payments are based on the achievement of performance targets, actual payments may be substantially lower. Substantially all of these contingent payments will be accounted for as goodwill, and the remaining amounts will be expensed, when earned. No contingent payments were earned through March 31, 2006.

During the three months ended March 31, 2006, we also acquired all of the voting interests of four other companies. One of these transactions was accounted for as a business combination. Because the remaining three transactions were with companies considered to be development stage enterprises, they were accounted for as asset purchases in accordance with EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. The total purchase price of this business combination and these asset purchases was \$79.2 million, which primarily consisted of cash payments of \$75.7 million. In addition, we are obligated to make additional cash payments of up to \$17.9 million if certain performance targets are met through March 2010. Since these contingent payments are based on the achievement of performance targets, actual payments may be substantially lower. Substantially all of these contingent payments will be accounted for as goodwill, and the remaining amounts will be expensed, when earned.

In addition, during the three months ended March 31, 2006, we acquired certain other intangible assets for total cash payments of \$15.7 million.

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

Goodwill	\$ 123,906
Patents and developed technology	40,387
Customer contracts and other	52,790
Net liabilities assumed	(6,059)
Deferred tax liabilities	(22,527)
Purchased in-process research and development	4,000
Total	\$ 192,497

Goodwill is not deductible for tax purposes. The developed technology, customer contracts and other intangible assets have a weighted-average useful life of 4.0 years from the date of acquisition. The amortization of these intangibles is not deductible for tax purposes.

Purchased in-process research and development of \$4.0 million in the three months ended March 31, 2006 was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. This amount is included in research and development expenses on the accompanying Condensed Consolidated Statements of Income and is not deductible for tax purposes.

Note 5. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the quarter ended March 31, 2006, are as follows (in thousands):

Balance as of December 31, 2005	\$ 194,900
Goodwill acquired	123,906
Balance as of March 31, 2006	\$ 318,806

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

	As of December 31, 2005		
	Gross		Net
	Carrying	Accumulated	Carrying
	Amount	Amortization	Value
Patents and developed technology	\$ 120,413	\$ 46,272	\$ 74,141
Customer contracts and other	26,145	17,503	8,642
Total	\$ 146,558	\$ 63,775	\$ 82,783

	As of March 31, 2006		
	Gross		Net
	Carrying	Accumulated	Carrying
	Amount	Amortization	Value
Patents and developed technology	\$ 155,724	\$ 57,942	\$ 97,782
Customer contracts and other	84,011	21,220	62,791
Total	\$ 239,735	\$ 79,162	\$ 160,573

Patents and developed technology and customer contracts and other have weighted-average useful lives from the date of purchase of 3.4 and 3.3 years.

Amortization expense of acquisition-related intangible assets for the three month ended March 31, 2006 was \$15.4 million.

Estimated amortization expense for acquisition-related intangible assets on our March 31, 2006 Condensed Consolidated Balance Sheet for each of the next five years is as follows (in thousands):

2006	\$ 45,945
2007	55,613
2008	37,582
2009	10,599
2010	9,535
Thereafter	1,299
	\$ 160,573

Note 6. Interest Income and Other, Net

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

	Three Months Ended	
	March 31,	March 31,
	2005	2006
	(unaudited)	
Interest income	\$ 11,729	\$ 78,924
Interest expense	(123)	(8)
Other	2,080	(10,997)
Interest income and other, net	\$ 13,686	\$ 67,919

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GOOGLE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Contingencies

Legal Matters

Certain 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 recently have litigated similar issues in other cases in the U.S., France, Germany, Italy, Israel and Austria. Adverse results in these lawsuits may result in, or even compel, a change in this practice which could result in a loss of revenue for us, which could harm our business.

Certain entities have also filed intellectual property claims against us, alleging that features of certain of our products, including Google Web Search, Google News, Google Image Search, and Google Book Search, infringe their rights. Adverse results in these lawsuits may include awards of damages and may also result in, or even compel, a change in our business practices, which could result in a loss of revenue for us or otherwise harm our business.

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 t