

Google Inc.  
Form 10-Q  
August 16, 2004  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

(Mark One)

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

For the Quarterly Period Ended June 30, 2004

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.**

Edgar Filing: Google Inc. - Form 10-Q

(Exact name of registrant as specified in its charter)

---

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**77-0493581**  
(I.R.S. Employer

Identification Number)

**1600 Amphitheatre Parkway**

**Mountain View, CA 94043**

(Address of principal executive offices)

(Zip code)

**(650) 623-4000**

(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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) YES  NO

At July 31, 2004, the number of shares outstanding of the registrant's Class A common stock, \$0.001 par value, Class B common stock, \$0.001 par value, and preferred stock was 12,398,854, 162,861,743 and 79,099,884, respectively.

---

**Table of Contents**

**GOOGLE INC.**

**Form 10-Q**

**For the Quarter Ended June 30, 2004**

**INDEX**

	<b>Page</b>
	<b>No.</b>
	<hr/>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
Item 1	
<u>Financial Statements</u>	
<u>Consolidated Balance Sheets June 30, 2004 (unaudited) and December 31, 2003</u>	1
<u>Consolidated Statements of Income Three and Six Months Ended June 30, 2004 and 2003 (unaudited)</u>	2
<u>Consolidated Statements of Cash Flows Six Months Ended June 30, 2004 and 2003 (unaudited)</u>	3
<u>Notes to Unaudited Consolidated Financial Statements</u>	4
Item 2	17
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
Item 3	50
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	
Item 4	51
<u>Controls and Procedures</u>	
<b><u>PART II. OTHER INFORMATION</u></b>	
Item 1	53
<u>Legal Proceedings</u>	
Item 2	53
<u>Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u>	
Item 3	53
<u>Defaults Upon Senior Securities</u>	
Item 4	53
<u>Submission of Matters to a Vote of Security Holders</u>	
Item 5	54
<u>Other Information</u>	
Item 6	54
<u>Exhibits and Reports on Form 8-K</u>	
<u>Signatures</u>	55
<u>Exhibit Index</u>	56
<u>Certifications</u>	

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****Google Inc.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except par value)

	As of December 31, 2003	As of June 30, 2004  (unaudited)
	<u>2003</u>	<u>2004</u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 148,995	\$ 254,698
Short-term investments	185,723	293,989
Accounts receivable, net of allowance of \$4,670 and \$5,611	154,690	191,187
Income taxes receivable		45,047
Deferred income taxes	22,105	30,334
Prepaid revenue share, expenses and other assets	48,721	66,634
	<u>560,234</u>	<u>881,889</u>
Total current assets	560,234	881,889
Property and equipment, net	188,255	320,718
Goodwill	87,442	87,442
Intangible assets, net	18,114	16,313
Prepaid revenue share, expenses and other assets, non-current	17,413	21,660
	<u>871,458</u>	<u>1,328,022</u>
Total assets	\$ 871,458	\$ 1,328,022
<b>Liabilities, Redeemable Convertible Preferred Stock Warrant and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 46,175	\$ 61,830
Accrued compensation and benefits	33,522	33,931
Accrued expenses and other current liabilities	26,411	41,054
Accrued revenue share	88,672	93,435
Deferred revenue	15,346	18,256
Income taxes payable	20,705	
Current portion of equipment leases	4,621	3,751
	<u>235,452</u>	<u>252,257</u>
Total current liabilities	235,452	252,257
Long-term portion of equipment leases	1,988	456
Deferred revenue, long-term	5,014	6,023
Liability for stock options exercised early, long-term	6,341	8,576
Deferred income taxes	18,510	42,199
Other long-term liabilities	1,512	1,512
Commitments and contingencies		

## Edgar Filing: Google Inc. - Form 10-Q

Redeemable convertible preferred stock warrant	13,871	
<b>Stockholders' equity:</b>		
Convertible preferred stock, \$0.001 par value, issuable in series: 164,782 and 164,782 shares authorized at December 31, 2003 and June 30, 2004, 71,662 and 79,099 shares issued and outstanding at December 31, 2003 and June 30, 2004, liquidation preference of \$40,815 and \$62,458 at December 31, 2003 and June 30, 2004	44,346	79,860
Class A and Class B common stock, \$0.001 par value: 700,000 shares authorized, 160,866 and 165,012 shares issued and outstanding, excluding 11,987 and 10,203 shares subject to repurchase at December 31, 2003 and June 30, 2004	161	165
Additional paid-in capital	725,219	956,882
Note receivable from officer/stockholder	(4,300)	
Deferred stock-based compensation	(369,668)	(352,815)
Accumulated other comprehensive income	1,660	(1,481)
Retained earnings	191,352	334,388
	<hr/>	<hr/>
<b>Total stockholders' equity</b>	<b>588,770</b>	<b>1,016,999</b>
	<hr/>	<hr/>
<b>Total liabilities, redeemable convertible preferred stock warrant and stockholders' equity</b>	<b>\$ 871,458</b>	<b>\$ 1,328,022</b>
	<hr/>	<hr/>

See accompanying notes.

Table of Contents

## Google Inc.

**CONSOLIDATED STATEMENTS OF INCOME**

(in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
	(unaudited)			
Revenues	\$ 311,199	\$ 700,212	\$ 559,817	\$ 1,351,835
Costs and expenses:				
Cost of revenues	117,401	326,377	204,596	641,775
Research and development	17,492	45,762	29,997	80,781
Sales and marketing	24,822	56,777	42,589	104,681
General and administrative	12,535	25,577	22,562	47,083
Stock-based compensation(1)	34,165	74,761	70,583	151,234
Total costs and expenses	206,415	529,254	370,327	1,025,554
Income from operations	104,784	170,958	189,490	326,281
Interest income (expense) and other, net	766	(1,498)	719	(1,198)
Income before income taxes	105,550	169,460	190,209	325,083
Provision for income taxes	73,382	90,397	132,241	182,047
Net income	\$ 32,168	\$ 79,063	\$ 57,968	\$ 143,036
Net income per share:				
Basic	\$ 0.24	\$ 0.51	\$ 0.44	\$ 0.93
Diluted	\$ 0.12	\$ 0.30	\$ 0.23	\$ 0.54
Number of shares used in per share calculations:				
Basic	135,710	155,441	131,525	153,263
Diluted	257,361	266,263	253,024	265,223

(1) Stock-based compensation is allocated as follows (see Note 1):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004

Edgar Filing: Google Inc. - Form 10-Q

	(unaudited)			
Cost of revenues	\$ 1,361	\$ 2,546	\$ 2,813	\$ 7,622
Research and development	18,814	45,836	38,237	92,102
Sales and marketing	7,093	13,431	14,711	27,576
General and administrative	6,897	12,948	14,822	23,934
	<u>34,165</u>	<u>74,761</u>	<u>70,583</u>	<u>151,234</u>

See accompanying notes.

**Table of Contents****Google Inc.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2003</b>	<b>2004</b>
	<b>(unaudited)</b>	
<b>Operating activities</b>		
Net income	\$ 57,968	\$ 143,036
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	15,885	49,824
Amortization of warrants	4,732	62
Amortization of intangibles	2,114	4,801
In-process research and development		950
Stock-based compensation	70,583	151,234
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(34,174)	(36,497)
Income taxes, net	16,619	42,950
Prepaid revenue share, expenses and other assets	(13,750)	(21,946)
Accounts payable	10,727	15,642
Accrued expenses and other liabilities	6,232	11,866
Accrued revenue share	35,923	4,763
Deferred revenue	4,315	3,919
<b>Net cash provided by operating activities</b>	<b>177,174</b>	<b>370,604</b>
<b>Investing activities</b>		
Purchases of property and equipment	(60,553)	(182,283)
Purchase of short-term investments	(89,528)	(471,081)
Maturities and sales of short-term investments	97,474	361,908
Acquisitions, net of cash acquired	(39,452)	(3,538)
<b>Net cash used in investing activities</b>	<b>(92,059)</b>	<b>(294,994)</b>
<b>Financing activities</b>		
Proceeds from exercise of stock options, net	7,845	8,553
Proceeds from exercise of warrants		21,877
Payments of notes receivable from stockholders		4,300
Payments of principal on capital leases and equipment loans	(3,946)	(2,403)
<b>Net cash provided by financing activities</b>	<b>3,899</b>	<b>32,327</b>
Effect of exchange rate changes on cash and cash equivalents	(689)	(2,234)
<b>Net increase in cash and cash equivalents</b>	<b>88,325</b>	<b>105,703</b>



Edgar Filing: Google Inc. - Form 10-Q

Cash and cash equivalents at beginning of year	57,752	148,995
Cash and cash equivalents at end of period	\$ 146,077	\$ 254,698
<b>Supplemental disclosures of cash flow information</b>		
Cash paid for interest	\$ 920	\$ 477
Cash paid for taxes	\$ 115,733	\$ 138,818
<b>Acquisition related activities:</b>		
Issuance of common stock in connection with acquisitions, net of deferred stock-based compensation	\$ 64,243	\$ 428
Reduction in income taxes payable due to warrant exercises	\$	\$ 93,244

See accompanying notes.

**Table of Contents**

**Google Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**Note 1. The Company and Summary of Accounting Policies**

*Nature of Operations*

Google Inc. ( Google or the Company ) was incorporated in California in September 1998. The Company re-incorporated in the State of Delaware in August 2003. The Company offers highly targeted advertising solutions, global Internet search solutions through its own destination Internet site and intranet solutions via an enterprise search appliance.

*Basis of Consolidation*

The consolidated financial statements include the accounts of Google and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated.

*Unaudited Interim Financial Information*

The accompanying consolidated balance sheet as of June 30, 2004, the consolidated statements of income for the three and six months ended June 30, 2003 and 2004, and the consolidated statements of cash flows for the six months ended June 30, 2003 and 2004 are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles. In the opinion of the Company's management, the unaudited interim consolidated financial statements include all adjustments of a normal recurring nature necessary for the fair presentation of the Company's financial position at June 30, 2004, its results of operations for the three and six months ended June 30, 2003 and 2004, and its cash flows for the six months ended June 30, 2003 and 2004. The results of operations for the three and six months ended June 30, 2004 are not necessarily indicative of the results to be expected for the year ending December 31, 2004.

These unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Registration Statement on Form 10 filed on April 29, 2004, as amended.

*Revenue Recognition*

## Edgar Filing: Google Inc. - Form 10-Q

The following table presents the Company's revenues (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2004	2003	2004
	(unaudited)			
Advertising revenues:				
Google web sites	\$ 183,102	\$ 343,442	\$ 341,002	\$ 646,974
Google Network web sites	117,583	346,226	198,801	679,978
Total advertising revenues	300,685	689,668	539,803	1,326,952
Licensing and other revenues	10,514	10,544	20,014	24,883
Net revenues	\$ 311,199	\$ 700,212	\$ 559,817	\$ 1,351,835

In the first quarter of 2000, the Company introduced its first advertising program through which it offered advertisers the ability to place text-based ads on Google web sites targeted to users' search queries. Advertisers paid the Company based on the number of times their ads were displayed on users' search results pages and the

**Table of Contents**

**Google Inc.**

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

**(unaudited)**

Company recognized revenue at the time these ads appeared. In the fourth quarter of 2000, the Company launched Google AdWords, an online self-service program that enables advertisers to place text-based ads on Google web sites. AdWords advertisers originally paid the Company based on the number of times their ads appeared on users' search results pages. In the first quarter of 2002, the Company began offering AdWords exclusively on a cost-per-click basis, so that an advertiser pays the Company only when a user clicks on one of its ads. The Company recognizes 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. Effective January 1, 2004, the Company now offers a single pricing structure to all of its advertisers based on the AdWords cost-per-click model.

Google AdSense is the program through which the Company distributes its advertisers' text-based ads for display on the web sites of the 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*, the Company recognizes as revenues the fees it receives from its advertisers. This revenue is reported gross primarily because the Company is the primary obligor to its advertisers.

The Company generates 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. The Company's policy is to recognize revenues from per-query search fees in the period queries are made and results are delivered.

The Company provides search services pursuant to certain AdSense agreements. Management believes 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.

The Company also generates fees from the sale and license of its Search Appliance, which includes hardware, software and 12 to 24 months of post-contract support. As 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 in accordance with Statement of Position 97-2, *Software Revenue Recognition*, as amended.

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

***Cost of Revenues***

## Edgar Filing: Google Inc. - Form 10-Q

Cost of revenues consists primarily of traffic acquisition costs. Traffic acquisition costs consist of payments made to Google Network members. These payments are primarily based on revenue share arrangements under which the Company pays its Google Network members most of the fees it receives from its advertisers. In addition, certain AdSense agreements obligate the Company 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. The Company amortizes guaranteed minimum revenue share prepayments (or accretes an amount payable to its 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. In addition, concurrent with the commencement of certain AdSense agreements the Company purchased certain items from, or provided other consideration to, its Google Network members. These amounts are amortized on a pro-rata basis over the related term of the agreement.

**Table of Contents**

**Google Inc.**

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

**(unaudited)**

Traffic acquisition costs were \$96.6 million and \$277.0 million in the three months ended June 30, 2003 and 2004, and \$166.7 million and \$548.0 million in the six months ended June 30, 2003 and 2004.

In addition, cost of revenues consists of the expenses associated with the operation of the Company's data centers, including depreciation, labor, energy and bandwidth costs. Cost of revenues also includes credit card and other transaction fees relating to processing customer transactions.

***Reclassification***

Revenues and cost of revenues amounts have been reclassified in all periods presented to reflect the reporting of revenues equal to the advertiser fees received by the Company. The Company had previously reported revenues net of payments and amounts owed to its Google Network members under its AdSense program.

***Stock-based Compensation***

Stock-based compensation as shown on the accompanying consolidated income statements consists of amortization of deferred stock-based compensation related to restricted shares and options to purchase Class A and Class B common stock to employees and the values of options to purchase such stock issued to non-employees.

As permitted by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-based Compensation* (SFAS 123), the Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations. Under APB 25, deferred compensation for options granted to employees is equal to its intrinsic value, determined as the difference between the exercise price and the reassessed value for accounting purposes of the underlying stock on the date of grant.

For purposes of financial accounting for employee stock-based compensation, management has applied hindsight within each year to arrive at reassessed values for the shares underlying the options. The Company has recorded deferred stock-based compensation equal to the difference between these reassessed values and the exercise prices.

## Edgar Filing: Google Inc. - Form 10-Q

In connection with restricted shares and unvested stock options granted to employees, the Company recorded deferred stock-based compensation costs of \$47.0 million and \$58.1 million for the three months ended June 30, 2003 and 2004, and \$176.3 million and \$134.2 million for the six months ended June 30, 2003 and 2004.

**Table of Contents****Google Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Net amortization of deferred stock-based compensation totaled \$30.4 million and \$72.1 million in the three months ended June 30, 2003 and 2004 and \$65.0 million and \$145.8 million in the six months ended June 30, 2003 and 2004. The deferred stock-based compensation is being amortized using the accelerated vesting method, in accordance with SFAS 123, EITF 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in connection with Selling, Goods or Services* ( EITF 96-18 ), and Financial Accounting Standards Board ( FASB ) Interpretation ( FIN ) No. 28, over the vesting period of each respective restricted share and stock option, generally over four or five years. The remaining unamortized, deferred stock-based compensation for all restricted shares and stock option grants through June 30, 2004 assuming no change in the stock option accounting rules and assuming all employees remain employed at Google for their remaining vesting periods will be expensed as follows over the remaining six months of 2004 and each of the next four years and thereafter (in millions):

	<b>(unaudited)</b>
2004	\$ 117.2
2005	137.7
2006	66.9
2007	24.1
2008	5.2
Thereafter	1.7
	<u>\$ 352.8</u>

The Company accounts for stock awards issued to non-employees in accordance with the provisions of SFAS 123 and EITF 96-18. Under SFAS 123 and EITF 96-18, the Company uses the Black-Scholes method to measure the value of options granted to non-employees at each vesting date to determine the appropriate charge to stock-based compensation.

The Company recorded stock-based compensation expense for the value of stock options earned by non-employees of \$3.8 million and \$2.7 million in the three months ended June 30, 2003 and June 30, 2004 and \$5.6 million and \$5.4 million in the six months ended June 30, 2003 and June 30, 2004. No options that vest over time were granted to non-employees in the six months ended June 30, 2004.

Pro forma information regarding net income has been determined as if the Company had accounted for its employee stock options under the method prescribed by SFAS 123. The resulting effect on pro forma net income disclosed may not be representative of the effects on net income on a pro forma basis in future years.



**Table of Contents****Google Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Had compensation cost for options granted under the option plans been determined based on the fair value method prescribed by SFAS 123, the Company's net income and net income per share would have been adjusted to the pro forma amounts below (in thousands, except per share data):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2003</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>
	<b>(unaudited)</b>			
Net income, as reported	\$ 32,168	\$ 79,063	\$ 57,968	\$ 143,036
Add: Stock-based employee compensation expense included in reported net income	30,370	72,086	64,989	145,803
Deduct: Total stock-based employee compensation expense under the fair value based method for all awards	(30,766)	(73,994)	(65,709)	(148,599)
<b>Net income, pro forma</b>	<b>\$ 31,772</b>	<b>\$ 77,155</b>	<b>\$ 57,248</b>	<b>\$ 140,240</b>
<b>Net income per share:</b>				
As reported basic	\$ 0.24	\$ 0.51	\$ 0.44	\$ 0.93
Pro forma basic	\$ 0.23	\$ 0.50	\$ 0.44	\$ 0.92
As reported diluted	\$ 0.12	\$ 0.30	\$ 0.23	\$ 0.54
Pro forma diluted	\$ 0.12	\$ 0.29	\$ 0.23	\$ 0.53

For purposes of the above pro forma calculation, the value of each option granted through June 30, 2004 was estimated on the date of grant using the Black-Scholes pricing model with the following weighted-average assumptions:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2003</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>
	<b>(unaudited)</b>			
Risk-free interest rate	1.68%	2.81%	1.87%	2.51%
Expected volatility	75%	75%	75%	75%
Expected life (in years)	3	3	3	3
Dividend yield				

## Edgar Filing: Google Inc. - Form 10-Q

The weighted-average fair value of an option granted in the three months ended June 30, 2003 and 2004 was \$27.06 and \$71.21 and in the six months ended June 30, 2003 and 2004 was \$16.18 and \$73.17, using the Black-Scholes pricing model.

### *Stock Options Exercised Early*

The Company typically allows employees to exercise options prior to vesting. Upon the exercise of an option prior to vesting, the exercising optionee is required to enter into a restricted stock purchase agreement with the Company, which provides that the Company has a right to repurchase the shares purchased upon exercise of the option at the original exercise price; provided, however, that its right to repurchase these shares will lapse in accordance with the vesting schedule included in the optionee's option agreement. In accordance with EITF 00-23, *Issues Related to Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*, stock options granted or modified after March 21, 2002, which are subsequently exercised for cash prior to vesting are treated differently from prior grants and related exercises. The consideration received for an exercise of an option granted after the effective date of this guidance is considered to be a deposit of the

**Table of Contents**

**Google Inc.**

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

**(unaudited)**

exercise price and the related dollar amount is recorded as a liability. The shares and liability are only reclassified into equity on a ratable basis as the award vests. The Company has applied this guidance and recorded a liability on the consolidated balance sheets relating to 11,987,482 and 10,203,007 of options granted subsequent to March 21, 2002 that were exercised and are unvested at December 31, 2003 and at June 30, 2004.

***Class A and Class B Common Stock***

The Company's certificate of incorporation previously provided that upon an initial public offering meeting certain criteria, the Company's Class A Senior common stock, which has ten votes per share, would automatically convert into common stock, which has one vote per share. In April 2004, the Company's Board of Directors authorized, and on June 25, 2004 its stockholders approved, certain amendments to the Company's certificate of incorporation. Pursuant to these amendments, each share of Class A Senior common stock was reclassified as one share of Class B common stock and each share of common stock was reclassified as one share of Class A common stock. In addition, these amendments changed the conversion rights of the Class A Senior common stock (now Class B common stock) to provide that these shares would no longer automatically convert into shares of common stock (now Class A common stock) upon an initial public offering. Also, shares of Class B common stock may be converted at any time at the option of the stockholder into Class A common stock and automatically convert upon any sale or transfer (subject to certain exceptions set forth in the certificate of incorporation). These amendments have been reflected in the accompanying consolidated financial statements as if they had been made at the inception of the Company.

***Stock Split***

In February and June 2003, the Company affected separate two-for-one stock splits. All references to Class A and Class B common stock and preferred stock shares and per share amounts including options and warrants to purchase Class A and Class B common stock have been retroactively restated to reflect the stock split as if such split had taken place at the inception of the Company.

***Net Income Per Share***

The Company computes 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 Class A and Class B common shares outstanding during the period except that it does not include unvested Class A and Class B common shares subject to repurchase or cancellation. Diluted net income per share is computed using the weighted average number of Class A and Class B common shares and, if dilutive, potential Class A and Class B common shares outstanding during the period. Potential Class A and Class B common shares consist of the incremental Class A and Class B common shares issuable upon the exercise of stock options, warrants, unvested common shares subject to repurchase or cancellation and convertible preferred stock. The dilutive effect of outstanding stock options and warrants is reflected in diluted earnings per share by application of the treasury stock method. Convertible preferred stock is reflected on an if-converted basis.



**Table of Contents****Google Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
	(unaudited)			
Basic and diluted net income per share:				
Numerator:				
Net income	\$ 32,168	\$ 79,063	\$ 57,968	\$ 143,036
Denominator:				
Weighted average Class A and Class B common shares outstanding	169,709	174,897	164,346	174,317
Less: Weighted average invested Class A and Class B common shares subject to repurchase or cancellation	(33,999)	(19,456)	(32,821)	(21,054)
Denominator for basic calculation	135,710	155,441	131,525	153,263
Effect of dilutive securities				
Add:				
Weighted average convertible preferred shares	70,756	76,545	70,593	74,103
Weighted average stock options and warrants and unvested Class A and Class B common shares subject to repurchase or cancellation	50,895	34,277	50,906	37,857
Denominator for diluted calculation	257,361	266,263	253,024	265,223
Net income per share, basic	\$ 0.24	\$ 0.51	\$ 0.44	\$ 0.93
Net income per share, diluted	\$ 0.12	\$ 0.30	\$ 0.23	\$ 0.54

**Derivative Financial Instruments**

The Company hedges certain net asset and liability exposures with forward foreign exchange contracts 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. No foreign currency hedge transactions were entered into prior to the three months ended June 30, 2004.

## Edgar Filing: Google Inc. - Form 10-Q

In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, The Company recognizes derivative instruments and hedging activities as either assets or liabilities on the balance sheet at fair value. Neither the cost nor the fair value of these forward foreign exchange contracts was material at June 30, 2004. Changes in the fair value of these instruments are recorded as interest income (expense) and other, net and were not material in the three months ended June 30, 2004. The notional principal of forward foreign exchange contracts to purchase U.S. dollars with Euros was \$116.9 million at June 30, 2004. There were no other forward foreign exchange contracts outstanding at June 30, 2004.

**Table of Contents****Google Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 2. Cash, Cash Equivalents and Short-term Investments**

Cash, cash equivalents and short-term investments consist of the following (in thousands):

	As of December 31, 2003	As of June 30, 2004
	<u>2003</u>	<u>2004</u>
Cash and cash equivalents	\$ 148,995	\$ 254,698
Short-term investments:		(unaudited)
Municipal securities	166,538	277,629
Market auction preferred securities(1)	8,000	3,000
U.S. government notes	11,185	13,360
Total short-term investments	<u>185,723</u>	<u>293,989</u>
Total cash, cash equivalents and short-term investments	<u>\$ 334,718</u>	<u>\$ 548,687</u>

- (1) Market auction preferred securities are securities with perpetual maturities that are structured with short-term reset dates of generally less than 90 days. At the end of the reset period, investors can sell or continue to hold the securities at par. These securities are classified in the table below based on their stated maturity dates.

The Company has not experienced any significant realized gains or losses on its investments in the periods presented. Gross unrealized gains and losses at December 31, 2003 and at June 30, 2004 were not material.

**Note 3. Contingencies*****Legal Matters***

## Edgar Filing: Google Inc. - Form 10-Q

See Note 6 for a discussion of a settlement agreement entered into between the Company and Yahoo! Inc.

Companies have also 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. A court in France has held us liable for allowing advertisers to select certain trademarked terms as keywords. We have appealed this decision. We were also subject to two lawsuits in Germany on similar matters where one court preliminarily reached a similar conclusion as the court in France while another court held that we are not liable for the actions of our advertisers prior to notification of trademark rights. We are litigating similar issues in other cases in the U.S., France, Germany and Italy. 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.

Currently, there is no other significant litigation pending against the Company other than as described above. From time to time, the Company may become a party to litigation and subject to claims incident to the ordinary course of the Company's business. Although the results of such litigation and claims in the ordinary course of business cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse effect on the Company's business, results of operations or financial condition. Regardless of outcome, litigation can have an adverse impact on the Company because of defense costs, diversion of management resources and other factors.



**Table of Contents**

**Google Inc.**