

Google Inc.
Form 10-Q
July 30, 2010
[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, 2010

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)

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Delaware
(State or other jurisdiction of

77-0493581
(I.R.S. Employer

incorporation or organization)

Identification Number)

1600 Amphitheatre Parkway

Mountain View, CA 94043

(Address of principal executive offices)

(Zip Code)

(650) 253-0000

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer (Do not check if a smaller reporting company) ☐ Smaller reporting company ☐

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

At July 26, 2010, there were 246,464,004 shares of Google's Class A common stock outstanding and 72,242,108 shares of Google's Class B common stock outstanding.

Table of Contents

GOOGLE INC.

INDEX

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
Item 1	
<u>Financial Statements</u>	
<u>Consolidated Balance Sheets December 31, 2009 and June 30, 2010 (unaudited)</u>	3
<u>Consolidated Statements of Income Three and Six Months Ended June 30, 2009 and 2010 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flows Six Months Ended June 30, 2009 and 2010 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
Item 2	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
Item 3	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	42
Item 4	
<u>Controls and Procedures</u>	43
<u>PART II. OTHER INFORMATION</u>	
Item 1	
<u>Legal Proceedings</u>	44
Item 1A	
<u>Risk Factors</u>	44
Item 2	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	56
Item 6	
<u>Exhibits</u>	57
<u>Signatures</u>	58
<u>Exhibit Index</u>	59
Certifications	

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

(In millions, except share and par value amounts which are reflected in thousands, and par value per share amounts)

	As of December 31, 2009	As of June 30, 2010 (unaudited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 10,198	\$ 10,713
Marketable securities	14,287	19,346
Accounts receivable, net of allowance of \$79 and \$56	3,178	3,308
Deferred income taxes, net	644	66
Income taxes receivable, net	23	309
Prepaid revenue share, expenses and other assets	837	1,419
Total current assets	29,167	35,161
Prepaid revenue share, expenses and other assets, non-current	415	452
Deferred income taxes, net, non-current	263	443
Non-marketable equity securities	129	377
Property and equipment, net	4,845	4,920
Intangible assets, net	775	904
Goodwill	4,903	5,788
Total assets	\$ 40,497	\$ 48,045
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 216	\$ 397
Accrued compensation and benefits	982	748
Accrued expenses and other current liabilities	570	753
Securities lending payable		2,870
Accrued revenue share	694	677
Deferred revenue	285	302
Total current liabilities	2,747	5,747
Deferred revenue, non-current	42	31
Income taxes payable, non-current	1,392	1,318
Other long-term liabilities	312	336
Stockholders' equity:		
Convertible preferred stock, \$0.001 par value, 100,000 shares authorized; no shares issued and outstanding		
Class A and Class B common stock and additional paid-in capital, \$0.001 par value: 9,000,000 shares authorized; 317,772 (Class A 243,611, Class B 74,161) and par value of \$318 (Class A \$244, Class B \$74) and 318,613 (Class A 246,165, Class B 72,448) and par value of \$319 (Class A \$246, Class B \$73) shares issued and outstanding	15,817	17,109

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Accumulated other comprehensive income	105	346
Retained earnings	20,082	23,158
Total stockholders' equity	36,004	40,613
Total liabilities and stockholders' equity	\$ 40,497	\$ 48,045

See accompanying notes.

Table of Contents**GOOGLE INC.****CONSOLIDATED STATEMENTS OF INCOME****(In millions, except per share amounts)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
Revenues	\$ 5,523	\$ 6,820	\$ 11,032	\$ 13,595
Costs and expenses:				
Cost of revenues (including stock-based compensation expense of \$14, \$8, \$26 and \$14)	2,108	2,467	4,209	4,919
Research and development (including stock-based compensation expense of \$182, \$202, \$352 and \$393)	708	898	1,349	1,716
Sales and marketing (including stock-based compensation expense of \$57, \$56, \$116 and \$110)	469	629	903	1,236
General and administrative (including stock-based compensation expense of \$40, \$43, \$77 and \$83)	364	461	814	871
Total costs and expenses	3,649	4,455	7,275	8,742
Income from operations	1,874	2,365	3,757	4,853
Interest and other income (expense), net	(18)	69	(11)	87
Income before income taxes	1,856	2,434	3,746	4,940
Provision for income taxes	371	594	839	1,145
Net income	\$ 1,485	\$ 1,840	\$ 2,907	\$ 3,795
Net income per share of Class A and Class B common stock:				
Basic	\$ 4.70	\$ 5.78	\$ 9.21	\$ 11.93
Diluted	\$ 4.66	\$ 5.71	\$ 9.15	\$ 11.77

See accompanying notes.

Table of Contents**GOOGLE INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In millions)**

	Six Months Ended June 30, 2009	2010 (unaudited)
Operating activities		
Net income	\$ 2,907	\$ 3,795
Adjustments:		
Depreciation and amortization of property and equipment	632	530
Amortization of intangibles and other assets	148	143
Stock-based compensation expense	571	600
Excess tax benefits from stock-based award activities	(36)	(31)
Deferred income taxes	(114)	(4)
Other	(23)	2
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(42)	(197)
Income taxes, net	(64)	(164)
Prepaid revenue share, expenses and other assets	88	(191)
Accounts payable	42	199
Accrued expenses and other liabilities	(281)	(75)
Accrued revenue share	19	34
Deferred revenue	12	28
Net cash provided by operating activities	3,859	4,669
Investing activities		
Purchases of property and equipment	(402)	(715)
Purchases of marketable securities	(10,636)	(25,421)
Maturities and sales of marketable securities	10,435	20,630
Investments in non-marketable equity securities	(28)	(230)
Cash collateral received from securities lending		2,870
Acquisitions, net of cash acquired, and purchases of intangible and other assets	(5)	(419)
Net cash used in investing activities	(636)	(3,285)
Financing activities		
Net proceeds related to stock-based award activities	10	1
Excess tax benefits from stock-based award activities	36	31
Repurchase of common stock in connection with acquisitions		(801)
Net cash provided by (used in) financing activities	46	(769)
Effect of exchange rate changes on cash and cash equivalents	(15)	(100)
Net increase in cash and cash equivalents	3,254	515
Cash and cash equivalents at beginning of year	8,657	10,198
Cash and cash equivalents at end of period	\$ 11,911	\$ 10,713

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Supplemental disclosures of cash flow information

Cash paid for income taxes	\$ 1,013	\$ 1,309
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Non-cash financing activity:

Fair value of common stock issued and vested options assumed in connection with acquisitions	\$	\$ 750
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See accompanying notes.

Table of Contents

GOOGLE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Google Inc. and Summary of Significant 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 hosted applications.

Basis of Consolidation

The 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 Consolidated Balance Sheet as of June 30, 2010, the Consolidated Statements of Income for the three and six months ended June 30, 2009 and 2010, and the Consolidated Statements of Cash Flows for the six months ended June 30, 2009 and 2010 are unaudited. These unaudited interim Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP). In our opinion, the unaudited interim Consolidated Financial Statements include all adjustments of a normal recurring nature necessary for the fair presentation of our financial position as of June 30, 2010, our results of operations for the three and six months ended June 30, 2009 and 2010, and our cash flows for the six months ended June 30, 2009 and 2010. The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of the results to be expected for the year ending December 31, 2010.

These unaudited interim Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and related notes included in our 2009 Annual Report on Form 10-K filed on February 12, 2010.

Use of Estimates

The preparation of interim 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 financial instruments, intangible assets and goodwill, useful lives of intangible assets and property and equipment, fair values of stock-based awards, 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**Note 2. Net Income Per Share of Class A and Class B Common Stock**

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

	For the Three Months Ended June 30, 2009		2010 (unaudited)		For the Six Months Ended June 30, 2009		2010	
	Class A	Class B	Class A	Class B	Class A	Class B	Class A	Class B
Basic net income per share:								
Numerator								
Allocation of undistributed earnings	\$ 1,134	\$ 351	\$ 1,418	\$ 422	\$ 2,218	\$ 689	\$ 2,920	\$ 875
Denominator								
Weighted-average common shares outstanding	241,143	74,763	245,411	72,939	240,731	74,856	244,777	73,346
Less: Weighted-average unvested common shares subject to repurchase or cancellation	(5)				(11)			
Number of shares used in per share computation	241,138	74,763	245,411	72,939	240,720	74,856	244,777	73,346
Basic net income per share	\$ 4.70	\$ 4.70	\$ 5.78	\$ 5.78	\$ 9.21	\$ 9.21	\$ 11.93	\$ 11.93
Diluted net income per share:								
Numerator:								
Allocation of undistributed earnings for basic computation	\$ 1,134	\$ 351	\$ 1,418	\$ 422	\$ 2,218	\$ 689	\$ 2,920	\$ 875
Reallocation of undistributed earnings as a result of conversion of Class B to Class A shares	351		422		689		875	
Reallocation of undistributed earnings to Class B shares		(2)		(5)		(4)		(11)
Allocation of undistributed earnings	\$ 1,485	\$ 349	\$ 1,840	\$ 417	\$ 2,907	\$ 685	\$ 3,795	\$ 864
Denominator								
Number of shares used in basic computation	241,138	74,763	245,411	72,939	240,720	74,856	244,777	73,346
Weighted-average effect of dilutive securities								
Add:								
Conversion of Class B to Class A common shares outstanding	74,763		72,939		74,856		73,346	
Unvested common shares subject to repurchase or cancellation	5				11			
Employee stock options including warrants issued under Transferable Stock Option program	2,116	72	3,162	72	1,941	82	3,376	77
Restricted shares and restricted stock units	514		974		350		1,048	
Number of shares used in per share computation	318,536	74,835	322,486	73,011	317,878	74,938	322,547	73,423
Diluted net income per share	\$ 4.66	\$ 4.66	\$ 5.71	\$ 5.71	\$ 9.15	\$ 9.15	\$ 11.77	\$ 11.77

The net income per share amounts are the same for Class A and Class B because the holders of each class are legally entitled to equal per share distributions whether through dividends or in liquidation.

Table of Contents**Note 3. Cash and Investments**

Cash, cash equivalents, and marketable securities consist of the following (in millions):

	As of December 31, 2009	As of June 30, 2010 (unaudited)
Cash and cash equivalents:		
Cash	\$ 4,303	\$ 2,293
Cash equivalents:		
Time deposits	3,740	984
Money market and other overnight funds ⁽¹⁾	2,153	6,274
U.S. government agencies	2	
U.S. government notes		1,152
Municipal securities		2
Corporate debt securities		8
Total cash and cash equivalents	10,198	10,713
	As of December 31, 2009	As of June 30, 2010 (unaudited)
Marketable securities:		
Time deposits	1,250	119
Money market mutual funds	28	5
U.S. government agencies	3,703	2,823
U.S. government notes	2,492	2,114
Foreign government bonds	37	1,002
Municipal securities	2,130	2,301
Corporate debt securities	2,822	5,851
Agency residential mortgage-backed securities	1,578	4,870
Commercial mortgage-backed securities	48	47
Marketable equity security	199	214
Total marketable securities	14,287	19,346
Total cash, cash equivalents and marketable securities	\$ 24,485	\$ 30,059

⁽¹⁾ The balance at June 30, 2010 includes \$2.9 billion of cash collateral received in connection with our securities lending program. See below for further discussion on this program. No similar amounts were outstanding as of December 31, 2009.

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

As of December 31, 2009

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	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Time deposits	\$ 1,250	\$	\$	\$ 1,250
Money market mutual funds	28			28
U.S. government agencies	3,700	5	(2)	3,703
U.S. government notes	2,520		(28)	2,492
Foreign government bonds	37			37
Municipal securities	2,100	30		2,130
Corporate debt securities	2,826	13	(17)	2,822
Agency residential mortgage-backed securities	1,585	5	(12)	1,578
Commercial mortgage-backed securities	47	1		48
Marketable equity security	145	54		199
Total	\$ 14,238	\$ 108	\$ (59)	\$ 14,287

Table of Contents

	As of June 30, 2010			Fair Value
	Adjusted Cost	Gross	Gross	
		Unrealized Gains	Unrealized Losses (unaudited)	
Time deposits	\$ 119	\$	\$	\$ 119
Money market mutual funds	5			5
U.S. government agencies	2,815	8		2,823
U.S. government notes	2,077	37		2,114
Foreign government bonds	994	12	(4)	1,002
Municipal securities	2,277	25	(1)	2,301
Corporate debt securities	5,785	98	(32)	5,851
Agency residential mortgage-backed securities	4,794	77	(1)	4,870
Commercial mortgage-backed securities	47			47
Marketable equity security	145	69		214
Total	\$ 19,058	\$ 326	\$ (38)	\$ 19,346

Gross unrealized gains and losses on cash equivalents were not material at December 31, 2009 and June 30, 2010.

Table of Contents

Our foreign government bonds consist of USD and non-USD denominated bonds issued by foreign governments.

Our corporate debt securities consist primarily of USD denominated securities issued by U.S. and non-U.S. corporations, as well as securities guaranteed by the full faith and credit of the U.S. government under the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program (TLGP) or the sovereign guarantee of foreign governments under similar programs to the TLGP.

Our agency residential mortgage-backed securities are specified pools of mortgage pass-through securities that are guaranteed by government-sponsored enterprises. Our commercial mortgage-backed securities are fully defeased securities with underlying collateral loans replaced by U.S. Treasury notes.

Our marketable equity security consists of our investment in Clearwire Corporation.

We recognized gross realized gains of \$20 million and \$53 million for the three months ended June 30, 2009 and 2010. We recognized gross realized gains of \$54 million and \$81 million for the six months ended June 30, 2009 and 2010. Gross realized losses were not material in all periods presented. We determine realized gains and losses on the sale of marketable securities on a specific identification method, and we reflect such gains and losses as a component of interest and other income (expense), net, in our accompanying Consolidated Statements of Income.

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

	As of June 30, 2010 (unaudited)
Due in 1 year	\$ 1,910
Due in 1 year through 5 years	6,518
Due in 5 years through 10 years	4,226
Due after 10 years	6,478
Total	\$ 19,132

The following tables present fair values and gross unrealized losses for those investments that were in an unrealized loss position as of December 31, 2009 and June 30, 2010, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in millions):

	As of December 31, 2009 Less than 12 Months	
Security Description	Fair Value	Unrealized Loss
U.S. government agencies	\$ 1,273	\$ (2)
U.S. government notes	2,492	(28)
Corporate debt securities	1,175	(17)
Agency residential mortgage-backed securities	1,040	(12)
Total	\$ 5,980	\$ (59)

	As of June 30, 2010 Less than 12 Months	
Security Description	Fair Value	Unrealized Loss

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	(unaudited)	
Municipal securities	\$ 311	\$ (1)
Corporate debt securities	1,615	(32)
Foreign government bonds	127	(4)
Agency residential mortgage-backed securities	352	(1)
Total	\$ 2,405	\$ (38)

Table of Contents

As of December 31, 2009 and June 30, 2010, we did not have any investments in marketable securities that were in an unrealized loss position for a period of 12 months or greater.

Auction Rate Securities

At June 30, 2010, we held \$168 million of auction rate securities (ARS). The assets underlying these 31 individual investments are primarily student loans which are mostly AAA rated and substantially guaranteed by the U.S. government under the Federal Family Education Loan Program. Historically, these securities have provided liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined intervals every 7 to 49 days. However, these auctions began to fail in the first quarter of 2008. Since these auctions have failed, we have realized higher interest rates for many of these ARS than we would have otherwise. Although we have been receiving interest payments at these generally higher rates, the related principal amounts will not be accessible until a successful auction occurs, a buyer is found outside of the auction process, the issuer calls the security, or the security matures according to contractual terms. Maturity dates for these ARS investments range from 2025 to 2047. Since these auctions have failed, \$79 million of the related securities were called at par by their issuers.

As a result of the auction failures, these ARS do not have a readily determinable market value. To estimate their fair values at June 30, 2010, we used a discounted cash flow model based on estimated interest rates, timing and amount of cash flows, the credit quality of the underlying securities, and illiquidity considerations. Specifically, we estimated the future cash flows of our ARS over the expected workout periods using a projected weighted-average interest rate of 3.1% per annum, which is based on the forward swap curve at the end of June 2010 plus any additional basis points currently paid by the issuers assuming these auctions continue to fail. A discount factor was applied over these estimated cash flows of our ARS, which is calculated based on the interpolated forward swap curve adjusted by up to 1,700 basis points to reflect the current market conditions for instruments with similar credit quality at the date of the valuation and further adjusted by up to 400 basis points to reflect a discount for the liquidity risk associated with these investments due to the lack of an active market.

At June 30, 2010, the estimated fair value of these ARS was \$23 million less than their costs. As we have no intent to sell these ARS and it is more likely than not that we will not be required to sell these ARS prior to recovery of our entire cost basis, we concluded the decline in the fair value was temporary and recorded the unrealized loss to accumulated other comprehensive income on the accompanying Consolidated Balance Sheet at June 30, 2010.

To the extent we determine that any impairment is other-than-temporary, we would record a charge to earnings. In addition, we have concluded that the auctions for these securities may continue to fail for at least the next 12 months and as a result, we classified them as non-current assets on the accompanying Consolidated Balance Sheet at June 30, 2010.

Securities Lending Program

From time to time, we enter into securities lending agreements with financial institutions to enhance investment income. We loan selected securities which are secured by collateral in the form of cash or securities. Cash collateral is invested in overnight reverse repurchase agreements. We continue to classify loaned securities as cash equivalents or marketable securities on the accompanying Consolidated Balance Sheets. We record cash collateral as an asset with a corresponding liability. For lending agreements collateralized by securities, we do not record an asset or liability as we are not permitted to sell or repledge the associated collateral.

Note 4. Derivative Financial Instruments

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

We recognize derivative instruments as either assets or liabilities on the accompanying Consolidated Balance Sheets at fair value. We record changes in the fair value (i.e., gains or losses) of the derivatives in the accompanying Consolidated Statements of Income as interest and other income (expense), net, as part of revenues, or to accumulated other comprehensive income (AOCI) on the accompanying Consolidated Balance Sheets.

Table of Contents

Cash Flow Hedges

We use options designated as cash flow hedges to hedge certain forecasted revenue transactions denominated in currencies other than the U.S. dollar. We initially report any gain on the effective portion of a cash flow hedge as a component of AOCI and subsequently reclassify to revenues when the hedged revenues are recorded or as interest and other income (expense), net, if the hedged transaction becomes probable of not occurring.

At June 30, 2010, the effective portion of our cash flow hedges before tax effect was \$356 million, of which \$257 million is expected to be reclassified from AOCI to revenues within the next 12 months.

We recognize any gain after a hedge is de-designated or related to an ineffective portion of a hedge in interest and other income (expense), net, immediately. Further, we exclude the change in the time value of the options from our assessment of hedge effectiveness. We record the premium paid or time value of an option whose strike price is equal to or greater than the market price on the date of purchase as an asset. Thereafter, we recognize any change to this time value in interest and other income (expense), net.

Table of Contents

The notional principal of foreign exchange contracts to purchase U.S. dollars with Euros was 1.6 billion (or approximately \$2.2 billion) and 2.6 billion (or approximately \$3.5 billion) at December 31, 2009 and June 30, 2010; the notional principal of foreign exchange contracts to purchase U.S. dollars with British pounds was £809 million (or approximately \$1.3 billion) and £1.5 billion (or approximately \$2.2 billion) at December 31, 2009 and June 30, 2010; and the notional principal of foreign exchange contracts to purchase U.S. dollars with Canadian dollars was C\$306 million (or approximately \$268 million) and C\$359 million (or approximately \$329 million) at December 31, 2009 and June 30, 2010. These foreign exchange options have maturities of 36 months or less. We have not designated any other foreign exchange contracts as cash flow hedges.

Fair Value Hedges

In November 2009, we began using forward contracts designated as fair value hedges to hedge foreign currency risks for our investments denominated in currencies other than the U.S. dollar. Gains and losses on these contracts are recognized in interest and other income (expense), net, along with the offsetting losses and gains of the related hedged items. We exclude changes in the time value for forward contracts from the assessment of hedge effectiveness and recognize them in interest and other income (expense), net. The notional principal of foreign exchange contracts to purchase U.S. dollars with foreign currencies was \$37 million and \$586 million at December 31, 2009 and June 30, 2010.

Other Derivatives

Other derivatives not designated as hedging instruments consist primarily of forward contracts that we use to hedge intercompany balances and other monetary assets or liabilities denominated in currencies other than the local currency of a subsidiary. We recognize gains and losses on these contracts as well as the related costs in interest and other income (expense), net, along with the gains and losses of the related hedged items. The notional principal of foreign exchange contracts to purchase U.S. dollars with foreign currencies was \$2.4 billion and \$2.6 billion at December 31, 2009 and June 30, 2010. The notional principal of foreign exchange contracts to sell U.S. dollars for foreign currencies was \$115 million and \$92 million at December 31, 2009 and June 30, 2010. The notional principal of foreign exchange contracts to purchase Euros with other currencies was \$618 million (or approximately \$889 million) and \$822 million (or approximately \$1.0 billion) at December 31, 2009 and June 30, 2010. The notional principal of foreign exchange contracts to sell Euros for other foreign currencies was \$8 million (or approximately \$11 million) at December 31, 2009 and no such contracts were outstanding at June 30, 2010.

At December 31, 2009 and June 30, 2010, the fair values of our outstanding derivative instruments are summarized below (in millions):

Balance Sheet Location		Fair Value of Derivative Instruments	
		As of December 31, 2009	As of June 30, 2010 (unaudited)
Derivative Assets			
Derivatives designated as hedging instruments:			
Foreign exchange option contracts	Prepaid revenue share, expenses and other assets, current and non-current	\$ 104	\$ 420
Foreign exchange forward contracts	Prepaid revenue share, expenses and other assets, current	1	
Total		\$ 105	\$ 420
Derivative Liabilities			
Derivatives designated as hedging instruments:			
Foreign exchange forward contracts	Accrued expenses and other current liabilities	\$	\$ 13
Derivatives not designated as hedging instruments:			
Foreign exchange forward contracts	Accrued expenses and other current liabilities		1
Total		\$	\$ 14

Table of Contents

The effect of derivative instruments in cash flow hedging relationship on income and other comprehensive income for the three and six months ended June 30, 2009 and 2010 is summarized below (in millions):

Derivatives in Cash Flow Hedging Relationship	Increase (Decrease) in Gains Recognized in AOCI on Derivative Before Tax Effect (Effective Portion)			
	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2009	2010	2009	2010
	(unaudited)			
Foreign exchange option contracts	\$ (164)	\$ 250	\$ (26)	\$ 430

Derivatives in Cash Flow Hedging Relationship	Location	Gains Reclassified from AOCI into Income (Effective Portion)			
		Three Months Ended		Six Months Ended	
		June 30,		June 30,	
		2009	2010	2009	2010
		(unaudited)			
Foreign exchange option contracts	Revenues	\$ 124	\$ 79	\$ 278	\$ 89

Derivatives in Cash Flow Hedging Relationship	Location	Gains (Losses) Recognized in Income on Derivative (Amount Excluded from Effectiveness Testing and Ineffective Portion) ⁽¹⁾			
		Three Months Ended		Six Months Ended	
		June 30,		June 30,	
		2009	2010	2009	2010
		(unaudited)			
Foreign exchange option contracts	Interest and other income (expense), net	\$ (93)	\$ (100)	\$ (193)	\$ (198)

⁽¹⁾ Gains (losses) related to the ineffective portion of the hedges were not material in all periods presented.

The effect of derivative instruments in fair value hedging relationship on income for the three and six months ended June 30, 2010 is summarized below (in millions):

Derivatives in Fair Value Hedging Relationship	Location	Gains (Losses) Recognized in Income on Derivatives ⁽²⁾	
		Three Months Ended	Six Months Ended
		June 30,	June 30, 2010
		2010	(unaudited)
Foreign exchange forward contracts	Interest and other income (expense), net	\$ 15	\$ 21
Hedged item	Interest and other income (expense), net	(15)	(21)
Total		\$	\$

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⁽²⁾ Gains (losses) related to the amount excluded from effectiveness testing of the hedges were not material in all periods presented. The effect of derivative instruments not designated as hedging instruments on income for the three and six months ended June 30, 2009 and 2010 is summarized below (in millions):

Derivatives not Designated as Hedging Instruments	Location	Gains (Losses) Recognized in Income on Derivative			
		Three Months Ended		Six Months Ended	
		June 30,		June 30,	
		2009	2010	2009	2010
		(unaudited)			
Foreign exchange forward contracts	Interest and				
	other income				
	(expense), net	\$ (146)	\$ 98	\$ (33)	\$ 196

Table of Contents

Note 5. Fair Value Measurements

We measure our cash equivalents, marketable securities, ARS, and foreign currency derivative contracts at fair value. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. A three-tier fair value hierarchy is established as a basis for considering such assumptions and for inputs used in the valuation methodologies in measuring fair value:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 Unobservable inputs that are supported by little or no market activities.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

We classify our cash equivalents and marketable securities within Level 1 or Level 2. This is because we value our cash equivalents and marketable securities using quoted market prices or alternative pricing sources and models utilizing market observable inputs. We classify our investments in ARS within Level 3 because they are valued using valuation techniques (see Note 3). Some of the inputs to these models are unobservable in the market and are significant. We classify our foreign currency derivative contracts within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments.

Table of Contents

Assets and liabilities measured at fair value on a recurring basis are summarized below (in millions):

Description	Fair value measurement at reporting date using			
	As of December 31, 2009	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Cash equivalents:				
Time deposits	\$ 3,740	\$	\$ 3,740	\$
Money market mutual funds	2,153	2,153		
U.S. government agencies	2		2	
Marketable securities:				
Time deposit	1,250		1,250	
Money market mutual funds	28		28	
U.S. government agencies	3,703		3,703	
U.S. government notes	2,492	2,492		
Foreign government bonds	37		37	
Municipal securities	2,130		2,130	
Corporate debt securities	2,822		2,822	
Agency residential mortgage-backed securities	1,578		1,578	
Commercial mortgage-backed securities	48		48	
Marketable equity security	199	199		
Foreign currency derivative contracts	105		105	
Auction rate securities	182			182
Total	\$ 20,469	\$ 4,844	\$ 15,443	\$ 182

Description	Fair value measurement at reporting date using			
	As of June 30, 2010	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2) (unaudited)	Significant Unobservable Inputs (Level 3)
Assets				
Cash equivalents:				
Time deposits	\$ 984	\$	\$ 984	\$
Money market and other overnight funds	6,274	3,404	2,870 ⁽¹⁾	
U.S. government notes	1,152	1,152		
Municipal securities	2		2	
Corporate debt securities	8		8	
Marketable securities:				
Time deposit	119		119	
Money market mutual funds	5		5	
U.S. government agencies	2,823		2,823	
U.S. government notes	2,114	2,114		
Foreign government bonds	1,002		1,002	
Municipal securities	2,301		2,301	
Corporate debt securities	5,851		5,851	
Agency residential mortgage-backed securities	4,870		4,870	
Commercial mortgage-backed securities	47		47	
Marketable equity security	214	214		

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Foreign currency derivative contracts	420		420	
Auction rate securities	168			168
Total	\$ 28,354	\$ 6,884	\$ 21,302	\$ 168

Liabilities

Foreign currency derivative contracts	\$ 14		\$ 14	
Total	\$ 14	\$	\$ 14	\$

Table of Contents

⁽¹⁾ This balance represents the cash collateral received in connection with our securities lending program.

The following table presents a reconciliation for our assets measured and recorded at fair value on a recurring basis, using significant unobservable inputs (Level 3) for the six months ended June 30, 2009 (in millions):

	Level 3 (unaudited)
Balance at December 31, 2008	\$ 197
Change in unrealized loss included in other comprehensive income	9
Net settlements	(12)
Balance at June 30, 2009	\$ 194

The following table presents a reconciliation for our assets measured and recorded at fair value on a recurring basis, using significant unobservable inputs (Level 3) for the six months ended June 30, 2010 (in millions):

	Level 3 (unaudited)
Balance at December 31, 2009	\$ 182
Change in unrealized loss included in other comprehensive income	
Net settlements	(14)
Balance at June 30, 2010	\$ 168

Note 6. Property and Equipment

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

	As of December 31, 2009	As of June 30, 2010 (unaudited)
Information technology assets	\$ 3,868	\$ 4,039
Construction in progress	1,644	1,802
Land and buildings	1,907	1,969
Leasehold improvements	646	651
Furniture and fixtures	65	64
Total	8,130	8,525
Less accumulated depreciation and amortization	3,285	3,605
Property and equipment, net	\$ 4,845	\$ 4,920

Note 7. Acquisitions

In May 2010, we completed the acquisition of AdMob, Inc. (AdMob), a privately-held mobile display ads technology provider. This transaction was accounted for as a business combination. The purchase price was \$681 million, consisting of the issuance of approximately 1.2 million shares of our Class A common stock and assumed vested options valued at \$655 million, and cash of \$26 million. The issued shares were valued based on the closing price of our Class A common stock on May 27, 2010. The fair values of stock options assumed were estimated using Black-Scholes-Merton option-pricing model.

Table of Contents

In February 2010, we completed the acquisition of On2 Technologies, Inc. (On2), a publicly-held company, and developer of video compression technology. This transaction was accounted for as a business combination. The purchase price was \$123 million, consisting of the issuance of approximately 174,000 shares of our Class A common stock valued at \$95 million, based on the closing price of our Class A common stock on February 19, 2010, and cash of \$28 million.

To offset the dilutive impact of issuing shares in connection with these acquisitions, we also repurchased and subsequently retired 1.6 million shares of our Class A common stock for \$801 million pursuant to Rule 10b5-1 trading plans.

During the six months ended June 30, 2010, we also completed 20 other acquisitions for a total cash consideration of approximately \$293 million.

The following table summarizes the allocation of the purchase price for all the acquisitions (in millions, unaudited):

	On2	AdMob	Other	Total
Goodwill	\$ 115	\$ 585	\$ 206	\$ 906
Patents and developed technology	27	20	86	133
Customer relationships	2	97	8	107
Tradenames and other		15	9	24
Net assets acquired (liabilities assumed)	(9)	7	5	3
Deferred tax liabilities	(12)	(43)	(21)	(76)
Total	\$ 123	\$ 681	\$ 293	\$ 1,097

For all acquisitions completed during the six months ended June 30, 2010, patents and developed technology and customer relationships have a weighted-average useful life of 3.2 years and tradenames and other have a weighted-average useful life of 2.5 years. The amount of goodwill expected to be deductible for tax purposes is \$35 million.

Note 8. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the six months ended June 30, 2010 are as follows (in millions, unaudited):

Balance as of December 31, 2009	\$ 4,903
Goodwill acquired	906
Goodwill adjustment	(21)
 Balance as of June 30, 2010	 \$ 5,788

Table of Contents

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

	As of December 31, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Patents and developed technology	\$ 566	\$ 380	\$ 186
Customer relationships	784	258	526
Tradenames and other	211	148	63
Total	\$ 1,561	\$ 786	\$ 775

	As of June 30, 2010		
	Gross Carrying Amount	Accumulated Amortization (unaudited)	Net Carrying Value
Patents and developed technology	\$ 718	\$ 434	\$ 284
Customer relationships	891	319	572
Tradenames and other	206	158	48
Total	\$ 1,815	\$ 911	\$ 904

Amortization expense of acquisition-related intangible assets for the three and six months ended June 30, 2009 was \$65 million and \$143 million and for the three and six months ended June 30, 2010 was \$70 million and \$133 million. As of June 30, 2010, expected amortization expense for acquisition-related intangible assets for each of the next five years and thereafter is as follows (in millions, unaudited):

Remainder of 2010	\$ 157
2011	271
2012	214
2013	133
2014	100
2015	19
Thereafter	10
	\$ 904

Note 9. Interest and Other Income (Expense), Net

The components of interest and other income (expense), net are as follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010 (unaudited)	2009	2010 (unaudited)
Interest income	\$ 50	\$ 136	\$ 116	\$ 232
Realized gains on marketable securities, net	18	43	50	68
Foreign currency exchange losses, net	(84)	(106)	(175)	(211)
Other	(2)	(4)	(2)	(2)

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Interest and other income (expense), net	\$ (18)	\$ 69	\$ (11)	\$ 87
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Table of Contents**Note 10. Comprehensive Income**

The changes in the components of other comprehensive income are as follows (in millions):

	Three Months Ended June 30, 2009		Six Months Ended June 30, 2009	
	2009	2010	2009	2010
	(unaudited)			
Net income	\$ 1,485	\$ 1,840	\$ 2,907	\$ 3,795
Change in unrealized gains (losses) on marketable securities, net of taxes ⁽¹⁾	(2)	165	7	207
Change in cumulative translation adjustment	86	(84)	28	(168)
Change in unrealized gains on cash flow hedges, net of taxes ⁽²⁾	(172)	102	(180)	202
Comprehensive income	\$ 1,397	\$ 2,023	\$ 2,762	\$ 4,036

⁽¹⁾ Change in unrealized gains (losses) on marketable securities is recorded net of taxes of \$2 million and \$30 million for the three months ended June 30, 2009 and 2010, and \$5 million and \$32 million for the six months ended June 30, 2009 and 2010.

⁽²⁾ Change in unrealized gains on cash flow hedges is recorded net of taxes of \$119 million and \$70 million for the three months ended June 30, 2009 and 2010, and \$125 million and \$139 million for the six months ended June 30, 2009 and 2010.

The components of accumulated other comprehensive income are as follows (in millions):

	As of December 31, 2009	As of June 30, 2010 (unaudited)
Unrealized net gains on available-for-sale investments, net of taxes	\$ 13	\$ 220
Foreign currency translation adjustment	83	(85)
Unrealized gains on cash flow hedges, net of taxes	9	211
Accumulated other comprehensive income	\$ 105	\$ 346

Note 11. Contingencies**Legal Matters**

Companies have filed trademark infringement and related claims against us over the display of ads in response to user queries that include trademark terms. The outcomes of these lawsuits have differed from jurisdiction to jurisdiction. In March 2010, the European Court of Justice issued a decision (with respect to three pending cases that were consolidated into one) that confirmed that we have not infringed trademark law by allowing advertisers to bid for keywords corresponding to their competitors' trademarks. We are litigating, or have recently litigated, similar issues in other cases, in the U.S., Australia, Austria, Brazil, Chile, China, France, Germany, Israel, Italy, Taiwan, and the United Kingdom.

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

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We have also had patent lawsuits filed against us alleging that certain of our products and services, including Android, Google Web Search, Google AdWords, Google AdSense, Google Talk, Google Chrome, and Google Voice infringe patents held by others. In addition, the number of demands for license fees and the dollar amounts associated

Table of Contents

with each demand continue to increase. Adverse results in these lawsuits, or our decision to license patents based upon these demands, may result in substantial costs and, in the case of adverse litigation results, could prevent us from offering certain features, functionalities, products, or services, which could result in a loss of revenues for us or otherwise harm our business.

We are also a party to other litigation and subject to claims incident to the ordinary course of business, including intellectual property claims (in addition to the trademark, copyright, and patent matters noted above), government investigations, labor and employment claims and threatened claims, breach of contract claims, tax, and other matters.

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

EPA Investigation

In February 2009, we learned of a U.S. Environmental Protection Agency (EPA) investigation into an alleged release of refrigerant at one of our smaller data facilities, which we acquired from DoubleClick, and the accuracy of related statements and records. We are cooperating with the EPA and have provided documents and other materials. The EPA investigation could result in fines, civil or criminal penalties, or other administrative action.

We believe this matter will not have a material adverse effect on our business, consolidated financial position, results of operations, or cash flows.

Income Taxes

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

Note 12. Stockholders' Equity

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010 (unaudited)	2009	2010
Risk-free interest rate	2.4%	2.6%	2.1%	2.6%
Expected volatility	38%	33%	40%	33%
Expected life (in years)	6.2	3.0	5.7	3.3
Dividend yield				
Weighted-average estimated fair value of options granted during the period	\$ 161.84	\$ 436.11	\$ 130.13	\$ 408.28

Table of Contents

The following table summarizes the activities for our options for the six months ended June 30, 2010:

		Options Outstanding			
	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions) (1)	
		(unaudited)			
Balance at December 31, 2009	12,776,488	\$ 298.73			
Granted	244,069	\$ 123.38			
Exercised	(484,190)	\$ 255.22			
Canceled/forfeited	(259,767)	\$ 349.53			
 Balance at June 30, 2010	 12,276,600	 \$ 296.43	 6.1	 \$ 1,848	
Vested and exercisable as of June 30, 2010	6,239,796	\$ 264.30	5.6	\$ 1,164	
Vested and exercisable as of June 30, 2010 and expected to vest thereafter ⁽²⁾	11,679,493	\$ 294.64	6.1	\$ 1,780	

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the closing stock price of \$444.95 of our Class A common stock on June 30, 2010.

(2) Options expected to vest reflect an estimated forfeiture rate.

Table of Contents

The following table summarizes additional information regarding outstanding, exercisable, and vested and exercisable stock options and warrants at June 30, 2010:

Options Outstanding				Options Exercisable			Options Vested and Exercisable	
Range of Exercise Prices		Number of Shares	Weighted-Average Remaining Life (Years)	Weighted-Average Exercise Price (unaudited)	Number of Shares	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
\$0.30	\$94.80	717,268	4.5	\$ 27.65	696,489	\$ 26.98	587,568	\$ 22.89
\$117.84	\$198.41	952,226	3.5	\$ 177.53	951,678	\$ 177.52	951,678	\$ 177.52
\$205.96	\$298.91	1,010,004	4.0	\$ 274.94	998,445	\$ 274.79	998,445	\$ 274.79
\$300.97	\$399.00	8,230,717	6.5	\$ 309.65	3,471,831	\$ 310.04	3,471,831	\$ 310.04
\$401.78	\$499.07	1,131,674	8.6	\$ 437.70	86,378	\$ 439.42	86,378	\$ 439.42
\$500.03	\$594.05	228,412	4.9	\$ 541.36	141,791	\$ 541.31	141,791	\$ 541.31
\$611.68	\$699.35	6,219	7.1	\$ 627.31	2,055	\$ 649.66	2,055	\$ 649.66
\$710.84		80	7.5	\$ 710.84	50	\$ 710.84	50	\$ 710.84
\$0.30	\$710.84	12,276,600	6.1	\$ 296.43	6,348,717	\$ 260.61	6,239,796	\$ 264.30

The above tables include approximately 1.5 million warrants held by selected financial institutions that were options purchased from employees under our Transferrable Stock Option (TSO) program, with a weighted-average exercise price of \$300.89.

The total grant date fair value of stock options vested during the three and six months ended June 30, 2010 was \$91 million and \$206 million. The total grant date fair value of stock options vested during the three and six months ended June 30, 2009 was \$30 million and \$143 million. The aggregate intrinsic value of all options and warrants exercised during the three and six months ended June 30, 2010 was \$86 million and \$133 million. The aggregate intrinsic value of all options and warrants exercised during the three and six months ended June 30, 2009 was \$104 million and \$211 million. These amounts do not include the aggregate sales price of options sold under our TSO program.

During the six months ended June 30, 2010, the number of shares underlying TSOs sold to selected financial institutions under the TSO program was 326,349 at a total value of \$81 million, or an average price of \$247.41 per share, including an average premium of \$19.74 per share. The premium is calculated as the difference between (a) the sale price of the TSO and (b) the intrinsic value of the TSO, which we define as the excess, if any, of the price of our Class A common stock at the time of the sale over the exercise price of the TSO.

As of June 30, 2010, there was \$899 million of unrecognized compensation cost related to outstanding employee stock options. This amount is expected to be recognized over a weighted-average period of 2.6 years. To the extent the forfeiture rate is different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

The following table summarizes the activities for our unvested restricted stock units (RSUs) and restricted shares for the six months ended June 30, 2010:

Unvested Restricted Stock Units and Restricted Shares		Weighted-Average Grant-Date Fair Value
Number of Shares		(unaudited)
Unvested at December 31, 2009	4,626,487	\$ 492.42
Granted	717,456	\$ 521.09
Vested	(659,527)	\$ 474.44

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Forfeited	(122,601)	\$ 480.16
Unvested at June 30, 2010	4,561,815	\$ 499.51
Expected to vest after June 30, 2010 ⁽¹⁾	4,110,195	\$ 499.51

Table of Contents

⁽¹⁾ RSUs and restricted shares expected to vest reflect an estimated forfeiture rate.

As of June 30, 2010, there was \$1,808 million of unrecognized compensation cost related to employee unvested RSUs and restricted shares. This amount is expected to be recognized over a weighted-average period of 2.6 years. To the extent the actual forfeiture rate is different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

Note 13. Income Taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. Our total unrecognized tax benefits as of December 31, 2009 and June 30, 2010 were \$1,188 million and \$1,151 million. Also, our unrecognized tax benefits at June 30, 2010 were reduced by \$245 million, none of which affected our income tax provision or effective tax rate. Our total unrecognized tax benefits that, if recognized, would affect our effective tax rate were \$814 million and \$957 million as of December 31, 2009 and June 30, 2010. Our existing tax positions will continue to generate an increase in liabilities for unrecognized tax benefits.

Note 14. Information about Geographic Areas

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

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

	Three Months Ended June 30, 20092010		Six Months Ended June 30, 20092010	
	(unaudited)			
Revenues:				
United States	\$ 2,609	\$ 3,288	\$ 5,236	\$ 6,484
United Kingdom	715	770	1,449	1,612
Rest of the world	2,199	2,762	4,347	5,499
Total revenues	\$ 5,523	\$ 6,820	\$ 11,032	\$ 13,595

	As of December 31, 2009	As of June 30, 2010 (unaudited)
Long-lived assets:		
United States	\$ 9,432	\$ 11,011
International	1,898	1,873
Total long-lived assets	\$ 11,330	\$ 12,884

Note 15. Subsequent Events

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On July 1, 2010, we signed a definitive agreement to acquire ITA Software, Inc. (ITA Software), a flight information software company, for \$700 million in cash, subject to adjustments. The completion of this transaction is subject to customary closing conditions. We expect this transaction to close in 2010.

On July 15, 2010, we announced our debt financing program of up to \$3 billion through the issuance of commercial paper. Net proceeds from the commercial paper program will be used for general corporate purposes. In conjunction with this program, we established a \$3 billion revolving credit facility at June 30, 2010. As of July 27, 2010, we had \$900 million of commercial paper issued and outstanding with a weighted-average yield of 0.2% that mature at various dates through November 2010. No amounts under either program were outstanding as of June 30, 2010.

Table of Contents

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, among other things, statements regarding:

the growth of our business and revenue;

seasonal fluctuations in internet usage and traditional retail seasonality, which are likely to cause fluctuations in our quarterly results;

our plans to continue to increase our hiring and invest in building the necessary systems infrastructures and to increase the number of acquisitions we expect to make in the remainder of 2010;

the decline in our revenue growth rate;

our expectation that growth in advertising revenues from our websites will continue to exceed that from our Google Network members' websites, which will have a positive impact on our operating margins;

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

our expectation that we will continue to take steps to improve the relevance of the ads we deliver and to reduce the number of accidental clicks;

fluctuations in aggregate paid clicks and average cost-per-click;

the fact that we will not recognize any revenue associated with sales of our mobile phone beyond the third quarter of 2010;

our belief that our foreign exchange risk management program will not fully offset the exposure to fluctuation in foreign currencies;

our expectation that our cost of revenues will increase in dollars and may increase as a percentage of revenues;

the fact that traffic acquisition costs may fluctuate in the future;

the timing for the consummation of our acquisition of ITA Software;

continued investments in international markets;

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our future stock-based compensation expenses;

the increase of costs related to hedging activities under our foreign exchange risk management program;

fluctuations in our effective tax rate;

the sufficiency of our sources of funding;

our payment terms to certain advertisers, which may increase our working capital requirements;

fluctuations in our capital expenditures; and

our belief that the EPA's investigation will not have a material adverse effect on our business, consolidated financial position, results of operations, or cash flows;

as well as other statements regarding our future operations, financial condition and prospects, and business strategies. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q, and in particular, the risks discussed under the heading "Risk Factors" in Part II, Item 1A and those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

Table of Contents

The following discussion and analysis of our financial condition and results of operations should be read together with our Consolidated Financial Statements and related notes included elsewhere in this Quarterly Report on Form 10-Q.

Overview

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

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

Advertisers. We provide advertisers with cost-effective ways to deliver online ads, as well as offline ads on television, to customers across Google sites and through the Google Network, which is the network of online and offline third parties that use our advertising programs to deliver relevant ads with their search results and content.

Google Network Members and Other Content Providers. We provide the online and offline members of our Google Network with our Google AdSense programs. These include programs through which we distribute our advertisers' AdWords ads for display on the websites of our Google Network members as well as programs to deliver ads on television broadcasts. We share most of the fees these ads generate with our Google Network members, thereby creating an important revenue stream for them. In addition, we have entered into arrangements with other content providers under which we distribute or license their video and other content, and we may display ads next to or as part of this content on the pages of our websites and our Google Network members' websites. We share most of the fees these ads generate with these content providers and our Google Network members, thereby creating an important revenue stream for these partners.

How We Generate Revenue

Advertising revenues made up 97% of our revenues for the three and six months ended June 30, 2009 and 96% of our revenues for the three and six months ended June 30, 2010. We derive most of our additional revenues from offering display advertising management services to advertisers, ad agencies, and publishers, as well as licensing our enterprise products, search solutions, and web search technology.

Google AdWords is our automated online program that enables advertisers to place targeted text-based and display ads on our websites and our Google Network members' websites. Display advertising typically includes static or animated images as well as interactive audio or video media, such as the banner ads on the tops or sides of many popular websites. Most of our AdWords customers pay us on a cost-per-click basis, which means that an advertiser pays us only when a user clicks on one of its ads. We also offer AdWords on a cost-per-impression basis that enables advertisers to pay us based on the number of times their ads appear on our websites and our Google Network members' websites as specified by the advertiser. For advertisers using our AdWords cost-per-click pricing, we recognize as revenue the fees charged advertisers each time a user clicks on one of the ads that appears next to the search results on our websites or next to the search results or content on our Google Network members' websites. For advertisers using our AdWords cost-per-impression pricing, we recognize as revenue the fees charged advertisers each time their ads are displayed on our websites or our Google Network members' websites. Our AdWords agreements are generally terminable at any time by our advertisers.

Table of Contents

Google AdSense refers to the online programs through which we distribute our advertisers' AdWords ads for display on the websites of our Google Network members as well as programs to deliver ads on television. Our AdSense programs include AdSense for search and AdSense for content.

AdSense for search is our online service for distributing relevant ads from our advertisers for display with search results on our Google Network members' sites. To use AdSense for search, most of our AdSense for search partners add Google search functionality to their web pages in the form of customizable Google search boxes. When visitors of these websites search either the website or the internet using these customizable search boxes, we display relevant ads on the search results pages, targeted to match user search queries. Ads shown through AdSense for search are text ads.

AdSense for content is our online service for distributing ads from our advertisers that are relevant to content on our Google Network members' websites. Under this program, we use automated technology to analyze the meaning of the content on the web page and serve relevant ads based on the meaning of such content. For example, a web page on an automotive blog that contains an entry about vintage cars might display ads for vintage car parts or vintage car shows. These ads are displayed in spaces that our AdSense for content partners have set aside on their websites. AdSense for content allows a variety of ad types to be shown, including text ads, image ads, Google Video Ads, link units (which are sets of clickable links to topic pages related to page content), themed units (which are regular text ads with graphic treatments that change seasonally and by geography), and gadget ads (which are customized mini-sites that run as ads on AdSense publisher websites).

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

Our agreements with Google Network members consist largely of uniform online click-wrap agreements that members enter into by interacting with our registration websites. The standard agreements have no stated term and are terminable at will. Agreements with our larger members are individually negotiated. Both the standard agreements and the negotiated agreements contain provisions requiring us to share with the Google Network member most of the advertiser fees generated by users clicking on ads on the Google Network member's website or, for advertisers who choose our cost-per-impression pricing, as the ads are displayed on the Google Network member's website. For example, under our standard agreements, we pay 51% and 68% of the fees collected from advertisers to our Google Network members in AdSense for search and AdSense for content, respectively.

Google TV Ads enable advertisers, operators, and programmers to buy, schedule, deliver, and measure ads on television. We recognize as revenue the fees charged advertisers each time an ad is displayed on television.

We also offer display advertising management services such as media planning, buying, implementation, and measurement tools for advertisers and agencies and forecasting and reporting tools for publishers. We recognize the related fees as other revenues in the period advertising impressions are delivered.

In January 2010, we launched our Nexus One mobile phone business. We recognize fees derived from the sale of mobile phones as other revenues in the period in which they are delivered. In July 2010, we discontinued our direct-to-consumer web store channel of distributing our mobile phone. Going forward, our partners will offer our mobile phone to consumers through existing retail channels. As a result, we will not recognize any revenue associated with the sale of our mobile phone beyond the third quarter of 2010.

Table of Contents

We have entered into arrangements with certain content providers under which we distribute or license their video and other content. Our agreements with content providers are typically standard agreements with no stated term and are terminable at will. Agreements with our larger members are individually negotiated. Both the standard agreements and the negotiated agreements contain provisions requiring us to pay the content providers for the content we license. In a number of these arrangements, we display ads on the pages of our websites and our Google Network members' websites from which the content is viewed and share most of the fees these ads generate with the content providers and Google Network members. We recognize these advertiser fees as revenue. We recognize the portion of the advertiser fees we pay to our content providers as content acquisition costs under cost of revenues and the portion we pay to our Google Network members as traffic acquisition costs. In some cases, we guarantee our content providers minimum revenue share or other payments.

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

The relevance, objectivity, and quality of our search results and the relevance and quality of ads displayed with each search results page.

The number of searches initiated at our websites and our Google Network members' websites and the underlying purpose of these searches (for instance, whether they are for academic research, to find a news article, or to find a product or service).

The number and prominence of ads displayed on our websites and our Google Network members' websites.

The number of visits to, and the content of, our Google Network members' websites and certain of our websites and the relevance and quality of the ads we display next to this content.

The advertisers' return on investment from advertising campaigns on our websites or our Google Network members' websites compared to other forms of advertising.

The total advertising spending budgets of each advertiser.

The number of advertisers and the breadth of items advertised.

The amount we ultimately pay our Google Network members, distribution partners, and our content providers for traffic, access points, and content compared to the amount of revenue we generate.

Our ability to increase searches on our websites and our Google Network members' websites via new ad formats on devices other than personal computers, including mobile devices.

Trends in Our Business

Our business has grown rapidly since inception, resulting in substantially increased revenues, and we expect that our business will continue to grow. However, our revenue growth rate has generally declined over time, and we expect it will continue to do so as a result of a number of factors, including increasing competition, the difficulty of maintaining growth rates as our revenues increase to higher levels, and increasing maturity of the online advertising market in certain countries. In addition, while general economic conditions have recently improved, the robustness and pace of the global economic recovery remains uncertain, which could negatively affect our revenue growth rate. However, we plan to continue to invest aggressively in our core areas of strategic focus.

Table of Contents

The main focus of our advertising programs is to provide relevant and useful advertising to our users, reflecting our commitment to constantly improve their overall web experience. As a result, we expect to continue to take steps to improve the relevance of the ads displayed on our websites and our Google Network members' websites. These steps include not displaying ads that generate low click-through rates or that send users to irrelevant or otherwise low quality sites and terminating our relationships with those Google Network members whose websites do not meet our quality requirements. We may also continue to take steps to reduce the number of accidental clicks by our users. These steps could negatively affect the growth rate of our revenues.

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

The operating margin we realize on revenues generated from ads placed on our Google Network members' websites through our AdSense program is significantly lower than the operating margin we realize from revenues generated from ads placed on our websites because most of the advertiser fees from ads served on Google Network members' websites are shared with our Google Network members. For the past five years, growth in advertising revenues from our websites has generally exceeded that from our Google Network members' websites. This trend has had a positive impact on our operating margins, and we expect that this will continue for the foreseeable future, although the relative rate of growth in revenues from our websites compared to the rate of growth in revenues from our Google Network members' websites may vary over time.

We continue to increase our hiring and invest in building the necessary systems infrastructures required to manage our growth and develop and promote our products and services, and this may cause our operating margins to decrease. We have generally experienced, and expect to continue to experience, growth in our operations as we build our research and development programs, expand our base of users, advertisers, Google Network members, and content providers, and increase our presence in international markets. Also, we have acquired and expect to continue to acquire businesses and other assets from time to time. In particular, we expect to increase the number of acquisitions we make in 2010 compared to 2009. These acquisitions generally enhance the breadth and depth of our expertise in engineering and other functional areas, our technologies, and our product offerings. Our full-time employee headcount was 19,786 at June 30, 2009 and 21,805 at June 30, 2010.

We expect our cost of revenues will increase in dollars and may increase as a percentage of revenues in future periods, primarily as a result of forecasted increases in traffic acquisition costs, data center costs, and credit card and other transaction fees, content acquisition costs, and other costs. In particular, traffic acquisition costs as a percentage of advertising revenues may increase in the future if we are unable to continue to improve the monetization or generation of revenues from traffic on our websites and our Google Network members' websites.

As we expand our advertising programs and other products to international markets, we continue to increase our exposure to fluctuations in foreign currency to U.S. dollar exchange rates. For example, in the second quarter of 2010, the general weakening of the U.S. dollar relative to foreign currencies (primarily the Australian dollar and the Japanese yen) had a favorable impact on our revenues as compared to the second quarter of 2009. We have a foreign exchange risk management program that is designed to reduce our exposure to fluctuations in foreign currencies. However, this program will not fully offset the effect of fluctuations on our revenues and earnings.

Table of Contents**Results of Operations**

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

	Three Months Ended June 30, 2009		Six Months Ended June 30, 2009	
	2010		2010	
(unaudited)				
Consolidated Statements of Income Data:				
Revenues	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Cost of revenues	38.2	36.2	38.2	36.2
Research and development	12.8	13.2	12.2	12.6
Sales and marketing	8.5	9.2	8.2	9.1
General and administrative	6.6	6.7	7.3	6.4
Total costs and expenses	66.1	65.3	65.9	64.3
Income from operations	33.9	34.7	34.1	35.7
Interest and other income (expense), net	(0.3)	1.0	(0.1)	0.6
Income before income taxes	33.6	35.7	34.0	36.3
Provision for income taxes	6.7	8.7	7.6	8.4
Net income	26.9%	27.0%	26.4%	27.9%

Revenues

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

	Three Months Ended June 30, 2009		Six Months Ended June 30, 2009	
	2010		2010	
	(unaudited)			
Advertising revenues:				
Google websites	\$ 3,653	\$ 4,499	\$ 7,345	\$ 8,938
Google Network websites	1,684	2,063	3,322	4,099
Total advertising revenues	5,337	6,562	10,667	13,037
Licensing and other revenues	186	258	365	558
Revenues	\$ 5,523	\$ 6,820	\$ 11,032	\$ 13,595

Table of Contents

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

	Three Months Ended June 30, 2009		Six Months Ended June 30, 2009	
	2010	(unaudited)	2010	
Advertising revenues:				
Google websites	66%	66%	67%	66%
Google Network websites	31	30	30	30
Total advertising revenues	97	96	97	96
Google websites as % of advertising revenues	68	69	69	69
Google Network websites as % of advertising revenues	32	31	31	31
Licensing and other revenues	3%	4%	3%	4%

The increase in our revenues from the three months ended June 30, 2009 to the three months ended June 30, 2010 and from the six months ended June 30, 2009 to the six months ended June 30, 2010 resulted primarily from an increase in advertising revenues generated by Google websites and Google Network members' websites, and to a lesser extent, an increase in other revenues as a result of the launch of our mobile phone business in the first quarter of 2010. These increases were partially offset by a decrease in hedging gains recognized in the three and six months ended June 30, 2010 compared to three and six months ended June 30, 2009. The increase in advertising revenue for Google websites and Google Network members' websites resulted primarily from an increase in the number of paid clicks through our advertising programs, and to a lesser extent, an increase in the average cost-per-click paid by our advertisers. The increase in the number of paid clicks generated through our advertising programs was due to an increase in aggregate traffic, certain monetization improvements including new ad formats, and the continued global expansion of our products, our advertiser and our user base, as well as an increase in the number of Google Network members. The increase in the average cost-per-click paid by our advertisers was primarily driven by the increased spending from advertisers, partially offset by the changes in geographical mix due to traffic growth in emerging markets, where average cost-per-clicks are typically lower, compared to more mature markets.

Improvements in our ability to ultimately monetize increased traffic primarily relate to enhancing the end user experience, including providing end users with ads that are more relevant to their search queries or to the content on the Google Network members' websites they visit. For instance, these improvements include enabling previously promoted high quality ads to be shown on subsequent pages, adding merchant ratings information to improve users' ability to evaluate ads, providing end users with multiple site links for certain web search ad results, reducing the minimum cost-per-click which results in the display of more relevant ads, and changing the clickable area around our AdSense for content text-based ads to only the title and URL to reduce the number of accidental clicks.

Aggregate paid clicks on Google websites and Google Network members' websites increased approximately 15% from the three months ended June 30, 2009 to the three months ended June 30, 2010 and 15% from the six months ended June 30, 2009 to the six months ended June 30, 2010. Average cost-per-click on Google websites and Google Network members' websites increased approximately 4% from the three months ended June 30, 2009 to the three months ended June 30, 2010 and 6% from the six months ended June 30, 2009 to the six months ended June 30, 2010. The rate of change in aggregate paid clicks and average cost-per-click, and their correlation with the rate of change in revenues, has fluctuated and may fluctuate in the future because of various factors including the revenue growth rates on our websites compared to those of our Google Network members, advertiser competition for keywords, changes in foreign currency exchange rates, seasonality, the fees advertisers are willing to pay based on how they manage their advertising costs, and general economic conditions. In addition, traffic growth in emerging markets compared to more mature markets and across various advertising verticals also contributes to these fluctuations. Changes in aggregate paid clicks and average cost-per-click may not be indicative of our performance or advertiser experiences in any specific geographic market, vertical, or industry.

Table of Contents

We believe that the increase in the number of paid clicks on Google websites and Google Network members' websites is substantially the result of our commitment to improving the relevance and quality of both our search results and the advertisements displayed, which we believe results in a better user experience, which in turn results in more searches, advertisers, and Google Network members and other partners.

Revenues by Geography

The following table presents our domestic and international revenues as a percentage of consolidated revenues, determined based on the billing addresses of our customers:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
United States	47%	48%	48%	48%
United Kingdom	13%	11%	13%	12%
Rest of the world	40%	41%	39%	40%

The decline in revenues from the United Kingdom as a percentage of consolidated revenues from the three and six months ended June 30, 2009 to the three and six months ended June 30, 2010 resulted primarily from a less robust economic recovery relative to the United States and rest of the world. The growth in revenues from the United States as a percentage of consolidated revenues from the three months ended June 30, 2009 to the three months ended June 30, 2010 resulted largely from the recovery of key verticals such as retail, travel, finance, and insurance. The growth in revenues from the rest of the world as a percentage of consolidated revenues from three and six months ended June 30, 2009 to the three and six months ended June 30, 2010 resulted largely from increased acceptance of our advertising programs and our continued progress in developing localized versions of our products for international markets, and the effect of the general weakening of the U.S. dollar compared to foreign currencies (primarily the Australian dollar).

The general weakening of the U.S. dollar relative to certain foreign currencies (primarily the Australian dollar and the Japanese yen) from the three months ended June 30, 2009 to the three months ended June 30, 2010 had a favorable impact on our international revenues. Had foreign exchange rates remained constant in these periods, our revenues from the United Kingdom would have been approximately \$5 million, or 1%, higher and our revenues from the rest of the world would have been approximately \$29 million, or 1%, lower in the three months ended June 30, 2010. This is before consideration of hedging gains of \$67 million and \$57 million recognized to revenues from the United Kingdom and the rest of the world in the three months ended June 30, 2009, and hedging gains of \$19 million and \$60 million recognized to revenues from the United Kingdom and the rest of the world in the three months ended June 30, 2010.

The general weakening of the U.S. dollar relative to certain foreign currencies (primarily the British pound, the Australian dollar, and the Brazilian real) from the six months ended June 30, 2009 to the six months ended June 30, 2010 had a favorable impact on our international revenues. Had foreign exchange rates remained constant in these periods, our revenues from the United Kingdom would have been approximately \$67 million, or 4%, lower and our revenues from the rest of the world would have been approximately \$199 million, or 4%, lower in the six months ended June 30, 2010. This is before consideration of hedging gains of \$149 million and \$129 million recognized to revenues from the United Kingdom and the rest of the world in the six months ended June 30, 2009 and hedging gains of \$29 million and \$60 million recognized to revenues from the United Kingdom and the rest of the world in the six months ended June 30, 2010.

Although we expect to continue to make investments in international markets, they may not result in an increase in our international revenues as a percentage of total revenues in 2010 or thereafter. See Note 14 of Notes to Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional information about geographic areas.

Table of Contents**Costs and Expenses***Cost of Revenues*

Cost of revenues consists primarily of traffic acquisition costs. Traffic acquisition costs consist of amounts ultimately paid to our Google Network members under AdSense arrangements and to certain other partners (our distribution partners) who distribute our toolbar and other products (collectively referred to as access points) or otherwise direct search queries to our website (collectively referred to as distribution arrangements). These amounts are primarily based on the revenue share arrangements with our Google Network members and distribution partners.

Certain distribution arrangements require us to pay our partners based on a fee per access point delivered and not exclusively or at all based on revenue share. The fees are non-refundable. Further, these arrangements are terminable at will, although under the terms of certain contracts, we or our distribution partners may be subject to penalties in the event of early termination. We recognize fees under these arrangements over the estimated useful lives of the access points (approximately two years) to the extent we can reasonably estimate those lives and they are longer than one year, or based on any contractual revenue share, if greater. Otherwise, we expense the fees as incurred. The estimated useful life of the access points is based on the historical average period of time they generate traffic and revenues.

Cost of revenues also includes the expenses associated with the operation of our data centers, including depreciation, labor, energy and bandwidth costs, credit card and other transaction fees related to processing customer transactions, amortization of acquired intangible assets, and content acquisition costs. We have entered into arrangements with certain content providers under which we distribute or license their video and other content. In a number of these arrangements we display ads on the pages of our websites and our Google Network members' websites from which the content is viewed and share most of the fees these ads generate with the content providers and the Google Network members. To the extent we are obligated to make guaranteed minimum revenue share or other payments to our content providers, we recognize content acquisition costs equal to the greatest of the following three amounts: 1) the contractual revenue share amount, if any, 2) an amount that is based on the number of times the content is displayed, or 3) an amount calculated on a straight-line basis over the terms of the agreements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
Cost of revenues	\$ 2,108	\$ 2,467	\$ 4,209	\$ 4,919
Cost of revenues as a percentage of revenues	38.2%	36.2%	38.2%	36.2%
Traffic acquisition costs related to AdSense arrangements	\$ 1,235	\$ 1,463	\$ 2,464	\$ 2,906
Traffic acquisition costs related to distribution arrangements	218	269	425	537
Traffic acquisition costs	\$ 1,453	\$ 1,732	\$ 2,889	\$ 3,443

Traffic acquisition costs as a percentage of advertising revenues 27.2% 26.4% 27.1% 26.4%

Cost of revenues increased \$359 million from the three months ended June 30, 2009 to the three months ended June 30, 2010. The increase was primarily related to an increase in traffic acquisition costs of \$228 million primarily resulting from more advertiser fees generated through our AdSense program. The increase was also related to an increase in traffic acquisition costs of \$51 million from our distribution arrangements as a result of more traffic directed to our websites as well as more distribution fees paid. The decrease in traffic acquisition costs as a percentage of advertising revenues was primarily due to more revenues realized from Google Network members to whom we paid less revenue share. In addition, there was an increase in content acquisition costs of \$32 million primarily related to content displayed on YouTube.

Table of Contents

Cost of revenues increased \$709 million from the six months ended June 30, 2009 to the six months ended June 30, 2010. The increase was primarily related to an increase in traffic acquisition costs of \$442 million primarily resulting from more advertiser fees generated through our AdSense program. The increase was also related to an increase in traffic acquisition costs of \$112 million from our distribution arrangements as a result of more traffic directed to our websites as well as more distribution fees paid. The decrease in traffic acquisition costs as a percentage of advertising revenues was primarily due to more revenues realized from Google Network members to whom we paid less revenue share.

We expect cost of revenues will increase in dollar amount and may increase as a percentage of revenues in 2010 and in future periods, primarily as a result of forecasted increases in traffic acquisition costs, data center costs, credit card and other transaction fees, content acquisition, and other costs. Traffic acquisition costs as a percentage of advertising revenues may fluctuate in the future based on a number of factors, including the following:

The relative growth rates of revenues from our websites and from our Google Network members' websites.

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

Whether we are able to continue to improve the monetization of traffic on our websites and our Google Network members' websites.

The relative growth rates of expenses associated with distribution arrangements and the related revenues generated, including whether we share with certain existing and new distribution partners proportionately more of the aggregate advertising fees that we earn from paid clicks derived from search queries these partners direct to our websites.

Research and Development

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
Research and development expenses	\$ 708	\$ 898	\$ 1,349	\$ 1,716
Research and development expenses as a percentage of revenues	12.8%	13.2%	12.2%	12.6%
Research and development expenses consist primarily of compensation and related costs for personnel responsible for the research and development of new and existing products and services. We expense research and development costs as they are incurred.				

Research and development expenses increased \$190 million from the three months ended June 30, 2009 to the three months ended June 30, 2010. This increase was primarily due to an increase in labor related costs of \$112 million primarily as a result of a 16% increase in research and development headcount, including headcount from acquisitions. In addition, there was an increase in stock-based compensation expense of \$20 million.

Research and development expenses increased \$367 million from the six months ended June 30, 2009 to the six months ended June 30, 2010. This increase was primarily due to an increase in labor related costs of \$231 million primarily as a result of a 16% increase in headcount, including headcount from acquisitions. In addition, there was an increase in stock-based compensation expense of \$41 million.

Table of Contents*Sales and Marketing*

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
Sales and marketing expenses	\$ 469	\$ 629	\$ 903	\$ 1,236
Sales and marketing expenses as a percentage of revenues	8.5%	9.2%	8.2%	9.1%
Sales and marketing expenses consist primarily of compensation and related costs for personnel engaged in customer service, sales, and sales support functions, as well as advertising and promotional expenditures.				

Sales and marketing expenses increased \$160 million from the three months ended June 30, 2009 to the three months ended June 30, 2010. This increase was primarily due to an increase in advertising and promotional expenses of \$77 million. In addition, there was an increase in labor related costs of \$40 million primarily due to higher commission expense and, to a lesser extent, a 6% increase in sales and marketing headcount.

Sales and marketing expenses increased \$333 million from the six months ended June 30, 2009 to the six months ended June 30, 2010. This increase was primarily due to an increase in advertising and promotional expenses of \$159 million. In addition, there was an increase in labor related costs of \$98 million primarily due to higher commission expense and, to a lesser extent, a 6% increase in sales and marketing headcount.

General and Administrative

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
General and administrative expenses	\$ 364	\$ 461	\$ 814	\$ 871
General and administrative expenses as a percentage of revenues	6.6%	6.7%	7.3%	6.4%
General and administrative expenses consist primarily of compensation and related costs for personnel and facilities related to our facilities, finance, human resources, information technology, and legal organizations, and fees for professional services. Professional services are principally comprised of outside legal, audit, information technology consulting, and outsourcing services.				

General and administrative expenses increased \$97 million from the three months ended June 30, 2009 to the three months ended June 30, 2010. This increase was primarily due to an increase in professional services of \$69 million, the majority of which related to legal costs and consulting services.

General and administrative expenses increased \$57 million from the six months ended June 30, 2009 to the six months ended June 30, 2010. This increase was primarily due to an increase in professional services of \$90 million, the majority of which related to legal costs and consulting services. This increase was partially offset by lower bad debt expense of \$45 million recognized as a result of general improved economic conditions.

Table of Contents*Stock-Based Compensation*

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
Stock-based compensation	\$ 293	\$ 309	\$ 571	\$ 600
Stock-based compensation as a percentage of revenues	5.3%	4.5%	5.2%	4.4%

Stock-based compensation increased \$16 million and \$29 million from the three and six months ended June 30, 2009 to the three and six months ended June 30, 2010. These increases were primarily due to additional stock awards issued to existing and new employees. The increase from the six months ended June 30, 2009 to the six months ended June 30, 2010 was also due to the recognition of a full quarter of modification charge in the three months ended March 31, 2010 compared to a partial quarter in the three months ended March 31, 2009 related to our stock option exchange program completed in March 2009.

We expect stock-based compensation to be approximately \$1.2 billion in 2010 and \$2.1 billion thereafter. These amounts do not include stock-based compensation related to stock awards that have been and may be granted to employees and directors subsequent to June 30, 2010 and stock awards that have been or may be granted to non-employees. In addition, to the extent forfeiture rates are different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

Interest and Other Income (Expense), Net

Interest and other income (expense), net increased \$87 million from the three months ended June 30, 2009 to the three months ended June 30, 2010. This increase was primarily driven by an increase in interest income of \$86 million due to an increase in our cash and investment balances and higher yields, as well as an increase in net realized gains on sales of marketable securities of \$25 million, partially offset by an increase in net foreign exchange related costs of \$22 million.

Interest and other income (expense), net increased \$98 million from the six months ended June 30, 2009 to the six months ended June 30, 2010. This increase was primarily driven by an increase in interest income of \$116 million due to an increase in our cash and investment balances and higher yields, as well as an increase in net realized gains on sales of marketable securities of \$18 million, partially offset by an increase in net foreign exchange related costs of \$36 million.

The costs of our foreign exchange hedging activities that we recognized to interest and other income (expense), net are primarily a function of the notional amount of the option and forward contracts and their related duration and the movement of the foreign exchange rates relative to the strike prices of the contracts as well as the volatility of the foreign exchange rates.

As we expand our international business, we believe costs related to hedging activities under our foreign exchange risk management program may increase in dollar amount in the remainder of 2010 and future periods.

Provision for Income Taxes

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
	(unaudited)			
Provision for income taxes	\$ 371	\$ 594	\$ 839	\$ 1,145
Effective tax rate	20.0%	24.4%	22.4%	23.2%

Table of Contents

Our provision for income taxes increased from the three months ended June 30, 2009 to the three months ended June 30, 2010, primarily as a result of increases in federal and state income taxes, driven by higher taxable income year over year. Our effective tax rate increased from the three months ended June 30, 2009 to the three months ended June 30, 2010, primarily because we expect more of our annual earnings in 2010 compared to 2009 to be realized in countries where we have higher statutory tax rates. This is primarily due to more hedging gains recognized in one of our legal entities that is subject to a higher statutory tax rate.

Our provision for income taxes increased from the six months ended June 30, 2009 to the six months ended June 30, 2010, primarily as a result of increases in federal and state income taxes, driven by higher taxable income year over year. Our effective tax rate increased from the six months ended June 30, 2009 to the six months ended June 30, 2010, primarily because we expect more of our annual earnings in 2010 compared to 2009 to be realized in countries where we have higher statutory tax rates largely due to more hedging gains recognized in one of our legal entities that is subject to a higher statutory tax rate. This increase was partially offset by recognition of less charges related to certain discrete items in the six months ended June 30, 2010 compared to the six months ended June 30, 2009.

Our effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected to the extent earnings are lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates. Our effective tax rate could also fluctuate due to the net gains and losses recognized by legal entities on certain hedges and related hedged intercompany and other transactions under our foreign exchange risk management program, by changes in the valuation of our deferred tax assets or liabilities, or by changes in tax laws, regulations, accounting principles, or interpretations thereof. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Liquidity and Capital Resources

In summary, our cash flows were as follows (dollars in millions):

	Six Months Ended June 30,	
	2009	2010
	(unaudited)	
Net cash provided by operating activities	\$ 3,859	\$ 4,669
Net cash used in investing activities	(636)	(3,285)
Net cash provided by (used in) financing activities	46	(769)

At June 30, 2010, we had \$30.1 billion of cash, cash equivalents, and marketable securities. Cash equivalents and marketable securities are comprised of highly liquid debt instruments of the U.S. government and its agencies, municipalities in the U.S., debt instruments issued by foreign governments, time deposits, money market and other overnight funds, including cash collateral received related to our securities lending program, mortgage-backed securities, and corporate securities. See Note 3 of Notes to Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion on the composition of our cash, cash equivalents, and marketable securities.

Our principal sources of liquidity are our cash, cash equivalents, and marketable securities, as well as the cash flow that we generate from our operations. At December 31, 2009 and June 30, 2010, we had unused letters of credit for approximately \$101 million and \$63 million. We believe that our sources of funding will be sufficient to satisfy our currently anticipated cash requirements through at least the next 12 months. Our liquidity could be negatively affected by a decrease in demand for our products and services. In addition, we may make acquisitions or license products and technologies complementary to our business and may need to raise additional capital through future debt or equity financing to provide for greater flexibility to fund any such acquisitions and licensing activities. Additional financing may not be available at all or on terms favorable to us.

Table of Contents

On July 1, 2010, we signed a definitive agreement to acquire ITA Software, a flight information software company, for \$700 million in cash, subject to adjustments. The completion of this transaction is subject to customary closing conditions. We expect this transaction to close in 2010.

On July 15, 2010, we also announced a debt financing program of up to \$3 billion through the issuance of commercial paper. Net proceeds from the commercial paper program will be used for general corporate purposes. In conjunction with this program, we established a \$3 billion revolving credit facility at June 30, 2010. As of July 27, 2010, we had \$900 million of commercial paper issued and outstanding with a weighted-average yield of 0.2% that mature at various dates through November 2010. No amounts under the program or the facility were outstanding as of June 30, 2010.

Cash provided by operating activities consisted of net income adjusted for certain non-cash items, including amortization, depreciation, deferred income taxes, excess tax benefits from stock-based award activities, stock-based compensation expense, and the effect of changes in working capital and other activities. Cash provided by operating activities in the six months ended June 30, 2010 was \$4,669 million and consisted of net income of \$3,795 million, adjustments for non-cash items of \$1,240 million and cash used in working capital and other activities of \$366 million. Adjustments for non-cash items primarily consisted of \$600 million of stock-based compensation expense, \$530 million of depreciation and amortization expense on property and equipment, and \$143 million of amortization of intangible and other assets, partially offset by \$31 million of excess tax benefits from stock-based award activities. In addition, the decrease in cash from changes in working capital activities primarily consisted of an increase of \$197 million in accounts receivable due to the growth in fees billed to our advertisers, an increase of \$191 million in prepaid revenue share, expenses and other assets, a net decrease of \$164 million of income taxes payable and deferred income taxes (which includes the same \$31 million of excess tax benefits from stock-based awards included under adjustments for non-cash items), partially offset by an increase in accounts payable of \$199 million. The decrease in income taxes payable and deferred income taxes was primarily a result of more estimated income taxes paid during the second quarter of 2010 for the year ending December 31 2010, partially offset by additional tax obligations accrued. The increase in accounts payable was primarily a result of the growth of our business.

Table of Contents

Cash provided by operating activities in the six months ended June 30, 2009 was \$3,859 million and consisted of net income of \$2,907 million, adjustments for non-cash items of \$1,178 million, and cash used in working capital and other activities of \$226 million. Adjustments for non-cash items primarily consisted of \$632 million of depreciation and amortization expense on property and equipment, \$571 million of stock-based compensation expense, and \$148 million of amortization of intangible and other assets, partially offset by \$114 million of deferred income taxes and \$36 million of excess tax benefits from stock-based award activities. In addition, the decrease in cash from changes in working capital activities primarily consisted of a decrease of \$281 million in accrued expenses and other liabilities primarily as a result of employee bonuses for the year ended December 31, 2008 paid in the first quarter of 2009, a net decrease of \$64 million of income taxes payable and deferred income taxes (which includes the same \$36 million of excess tax benefits from stock-based awards included under adjustments for non-cash items), an increase of \$42 million in accounts receivable due to the growth in fees billed to our advertisers, partially offset by a decrease of \$88 million in prepaid revenue share, expenses and other assets, an increase in accounts payable of \$42 million, and to a lesser extent, by an increase in accrued revenue share of \$19 million. The decrease in income taxes payable and deferred income taxes was primarily a result of more estimated income taxes paid during the first half of 2009 for the year ended December 31, 2009, partially offset by additional tax obligations accrued.

As we expand our business internationally, we have offered payment terms to certain advertisers that are standard in their locales but longer than terms we would generally offer to our domestic advertisers. This may increase our working capital requirements and may have a negative effect on cash provided by our operating activities.

Cash used in investing activities in the six months ended June 30, 2010 of \$3,285 million was primarily attributable to net purchases of marketable securities of \$4,791 million, capital expenditures of \$715 million, and cash consideration used in acquisitions and other investments of \$649 million. This was partially offset by \$2,870 million of cash collateral that we received in connection with our securities lending program.

Cash used in investing activities in the six months ended June 30, 2009 of \$636 million was primarily attributable to capital expenditures of \$402 million and net purchases of marketable securities of \$201 million.

Capital expenditures are mainly for the purchase of information technology assets. In order to manage expected increases in internet traffic, advertising transactions, and new products and services, and to support our overall global business expansion, we will make significant investments in data center operations, technology, corporate facilities, and information technology infrastructure in the remainder of 2010 and thereafter. However, the amount of our capital expenditures has fluctuated and may continue to fluctuate on a quarterly basis.

Table of Contents

In addition, we expect to spend a significant amount of cash on acquisitions and other investments from time to time. In particular, we expect to increase the number of acquisitions we make in the remainder of 2010 compared to 2009. These acquisitions generally enhance the breadth and depth of our expertise in engineering and other functional areas, our technologies, and our product offerings. In connection with certain acquisitions, we are obligated to make additional cash payments if certain criteria are met. As of June 30, 2010, the remaining contingent obligation amount related to these acquisitions was approximately \$20 million, which if the criteria are met, would be recorded as part of the purchase price. Because these contingent payments are based on the achievement of performance targets, actual payments may be substantially lower.

Cash used in financing activities in the six months ended June 30, 2010 of \$769 million was primarily related to \$801 million in stock repurchases pursuant to Rule 10b5-1 trading plans in connection with our acquisitions of AdMob and On2 Technologies, Inc., partially offset by excess tax benefits of \$31 million from stock-based award activities during the period which represented a portion of the \$115 million reduction to income taxes payable that we recorded in the first half of 2010 related to the total direct tax benefit realized from the exercise, sale, or vesting of these awards.

Cash provided by financing activities in the six months ended June 30, 2009 of \$46 million was primarily due to excess tax benefits of \$36 million from stock-based award activities during the period which represents a portion of the \$108 million reduction to income taxes payable that we recorded in the first half of 2009 related to the total direct tax benefit realized from the exercise, sale, or vesting of these awards, as well as net proceeds related to stock-based award activities of \$10 million.

Contractual Obligations

We recorded long-term taxes payable of \$122 million in the six months ended June 30, 2010 related to tax positions for which the timing of the ultimate resolution is uncertain. At this time, we are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

Critical Accounting Policies and Estimates

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

Income Taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes.

Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome

Table of Contents

of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest.

Our effective tax rates have differed from the statutory rate primarily due to the tax impact of foreign operations, state taxes, certain benefits realized related to stock option activities, and research and experimentation tax credits. Our effective tax rates were 20.0% and 22.4% for the three and six months ended June 30, 2009 and 24.4% and 23.2% for the three and six months ended June 30, 2010. Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, the net gains and losses recognized by legal entities on certain hedges and related hedged intercompany and other transactions under our foreign exchange risk management program, changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws, regulations, accounting principles, or interpretations thereof. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Stock-Based Compensation

Our stock-based compensation expense is estimated at the grant date based on the award's fair value as calculated by the Black-Scholes-Merton (BSM) option-pricing model and is recognized as expense over the requisite service period. The BSM model requires various highly judgmental assumptions including expected volatility and option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience. To the extent our actual forfeiture rate is different from our estimate, stock-based compensation expense is adjusted accordingly.

Impairment of Marketable and Non-Marketable Securities

We periodically review our marketable securities and our non-marketable equity securities for impairment. If we conclude that any of these investments are impaired, we determine whether such impairment is other-than-temporary. Factors we consider to make such determination include the duration and severity of the impairment, the reason for the decline in value, the potential recovery period, and our intent to sell, or whether it is more likely than not that we will be required to sell, the investment before recovery. If any impairment is considered other-than-temporary, we will write down the asset to its fair value and take a corresponding charge to our Consolidated Statement of Income.

Available Information

Our website is located at www.google.com, and our investor relations website is located at <http://investor.google.com>. The following filings are available through our investor relations website after we file them with the Securities and Exchange Commission (SEC): Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and our Proxy Statements for our annual meetings of stockholders (for the last two years). We also provide a link to the section of the SEC's website at www.sec.gov that has all of our public filings. Our Annual Reports, Quarterly Reports, and Proxy Statements for the last two years are also available for download free of charge on our investor relations website. Further, a copy of this Quarterly Report on Form 10-Q is located at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports, proxy and information statements, and other information regarding our filings at www.sec.gov.

We webcast our earnings calls and certain events we participate in or host with members of the investment community on our investor relations website. Additionally, we provide notifications of news or announcements regarding our financial performance, including SEC filings, investor events, press and earnings releases, and blogs as part of our investor relations website. The contents of these websites are not intended to be incorporated by reference into this Quarterly Report on Form 10-Q or in any other report or document we file, and any references to these websites are intended to be inactive textual references only.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Foreign Exchange Risk

Economic Exposure

We transact business in various foreign currencies and have significant international revenues as well as costs denominated in foreign currencies. This exposes us to foreign currency risk. We purchase foreign exchange option contracts to reduce the volatility of cash flows related to forecasted revenues denominated in certain foreign currencies. The objective of the foreign exchange contracts is to better ensure that the U.S. dollar-equivalent cash flows are not adversely affected by changes in the U.S. dollar/foreign currency exchange rates. These contracts are designated as cash flow hedges. The gain on the effective portion of a cash flow hedge is initially reported as a component of accumulated other comprehensive income and subsequently reclassified into revenues when the hedged revenues are recorded or as interest and other income (expense), net, if the hedged transaction becomes probable of not occurring. Any gain after a hedge is de-designated or related to an ineffective portion of a hedge is recognized as interest and other income (expense), net, immediately.

At December 31, 2009, the notional principal and fair value of foreign exchange contracts to purchase U.S. dollars with Euros were 1.6 billion (or approximately \$2.2 billion) and \$59 million; the notional principal and fair value of foreign exchange contracts to purchase U.S. dollars with British pounds were £809 million (or approximately \$1.3 billion) and \$39 million; and the notional principal and fair value of foreign exchange contracts to purchase U.S. dollars with Canadian dollars were C\$306 million (or approximately \$268 million) and \$6 million. At June 30, 2010, the notional principal and fair value of foreign exchange contracts to purchase U.S. dollars with Euros were 2.6 billion (or approximately \$3.5 billion) and \$317 million; the notional principal and fair value of foreign exchange contracts to purchase U.S. dollars with British pounds were £1.5 billion (or approximately \$2.2 billion) and \$94 million; and the notional principal and fair value of foreign exchange contracts to purchase U.S. dollars with Canadian dollars were C\$359 million (or approximately \$329 million) and \$9 million. These foreign exchange options have maturities of 36 months or less. There are no other foreign exchange contracts designated as cash flow hedges. However, we may enter into similar contracts in other foreign currencies in the future.

We considered the historical trends in currency exchange rates and determined that it was reasonably possible that changes in exchange rates of 20% for our foreign currencies instruments could be experienced in the near term.

If the U.S. dollar weakened by 20%, the amount recorded in accumulated other comprehensive income before tax effect would have been approximately \$304 million lower at June 30, 2010, and the total amount of expense recorded as interest and other income (expense), net, would have been approximately \$28 million higher in the three months ended June 30, 2010. If the U.S. dollar strengthened by 20%, the amount recorded in accumulated other comprehensive income before tax effect would have been approximately \$1.1 billion higher at June 30, 2010, and the total amount of expense recorded as interest and other income (expense), net, would have been approximately \$119 million higher in the three months ended June 30, 2010.

Transaction Exposure

Our exposure to foreign currency transaction gains and losses is the result of certain net receivables due from our foreign subsidiaries and customers being denominated in currencies other than the functional currency of the subsidiary, primarily the Euro, the British pound, and the Japanese yen. Our foreign subsidiaries conduct their businesses in local currency. We have entered into foreign exchange contracts to offset the foreign exchange risk on certain monetary assets and liabilities denominated in currencies other than the local currency of the subsidiary.

The notional principal of foreign exchange contracts to purchase U.S. dollars with foreign currencies was \$2.4 billion and \$2.6 billion at December 31, 2009 and June 30, 2010. The notional principal of foreign exchange contracts to sell U.S. dollars for foreign currencies was \$115 million and \$92 million at December 31, 2009 and June 30, 2010. The notional principal of foreign exchange contracts to purchase Euros with other currencies was 618 million (or approximately \$889 million) and 822 million (or approximately \$1.0 billion) at December 31, 2009 and June 30, 2010. The notional principal of foreign exchange contracts to sell Euros for other foreign currencies was 8 million (or approximately \$11 million) at December 31, 2009.

Table of Contents

We considered the historical trends in currency exchange rates and determined that it was reasonably possible that adverse changes in exchange rates of 20% for all currencies could be experienced in the near term. These changes would have resulted in an adverse impact on income before income taxes of approximately \$102 million and \$15 million at December 31, 2009 and June 30, 2010. The adverse impact at December 31, 2009 and June 30, 2010 is after consideration of the offsetting effect of approximately \$594 million and \$706 million from forward exchange contracts in place for the months of December 2009 and June 2010. These reasonably possible adverse changes in exchange rates of 20% were applied to total monetary assets and liabilities denominated in currencies other than the local currencies at the balance sheet dates to compute the adverse impact these changes would have had on our income before taxes in the near term.

Interest Rate Risk

We invest our excess cash primarily in highly liquid debt instruments of the U.S. government and its agencies, municipalities in the U.S., debt instruments issued by foreign governments, time deposits, money market and other overnight funds, mortgage-backed securities, and corporate securities. By policy, we limit the amount of credit exposure to any one issuer.

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

We considered the historical volatility of short term interest rates and determined that it was reasonably possible that an adverse change of 100 basis points could be experienced in the near term. A hypothetical 1.00% (100 basis-point) increase in interest rates would have resulted in a decrease in the fair values of our marketable securities of approximately \$291 million and \$713 million at December 31, 2009 and June 30, 2010.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

Based on our evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

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

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

Table of Contents

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

EPA Investigation

In February 2009, we learned of a U.S. Environmental Protection Agency (EPA) investigation into an alleged release of refrigerant at one of our smaller data facilities, which we acquired from DoubleClick, and the accuracy of related statements and records. We are cooperating with the EPA and have provided documents and other materials. The EPA investigation could result in fines, civil or criminal penalties, or other administrative action.

While we believe this matter will not have a material adverse effect on our business, consolidated financial position, results of operations, or cash flows, we have noted it in accord with SEC regulations that call for disclosure of certain environmental proceedings that may result in monetary sanctions of \$100,000 or more.

ITEM 1A. RISK FACTORS

Risks Related to Our Business and Industry

We face intense competition.

Our business is rapidly evolving and intensely competitive, and is subject to changing technology, shifting user needs, and frequent introductions of new products and services. We have many competitors in different industries, including general purpose search engines, vertical search engines and e-commerce sites, social networking sites, traditional media companies, and providers of online products and services. Our current and potential competitors range from large and established companies to emerging start-ups. Established companies have longer operating histories and more established relationships with customers and end users, and they can use their experience and resources against us in a variety of competitive ways, including by making acquisitions, investing aggressively in research and development, and competing aggressively for advertisers and websites. Emerging start-ups may be able to innovate and provide products and services faster than we can. If our competitors are more successful than we are in developing compelling products or in attracting and retaining users, advertisers, and content providers, our revenues and growth rates could decline.

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

Our success depends on providing products and services that make using the internet a more useful and enjoyable experience for our users. Our competitors are constantly developing innovations in web search, online advertising, and web based products and services. As a result, we must continue to invest significant resources in research and development in order to enhance our web search technology and our existing products and services and introduce new products and services that people can easily and effectively use. If we are unable to provide quality products and services, then our users may become dissatisfied and move to a competitor's products and services. In addition, these new products and services may present new and difficult technology challenges, and we may be subject to claims if users

Table of Contents

of these offerings experience service disruptions or failures or other quality issues. Our operating results would also suffer if our innovations are not responsive to the needs of our users, advertisers, and Google Network members, are not appropriately timed with market opportunities, or are not effectively brought to market. As search technology continues to develop, our competitors may be able to offer search results that are, or that are seen to be, substantially similar to or better than ours. This may force us to compete in different ways and expend significant resources in order to remain competitive.

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

We generated 97% of our revenues in 2009 and 96% of our revenues in the first half of 2010 from our advertisers. Our advertisers can generally terminate their contracts with us at any time. Advertisers will not continue to do business with us if their investment in advertising with us does not generate sales leads, and ultimately customers, or if we do not deliver their advertisements in an appropriate and effective manner. In addition, expenditures by advertisers tend to be cyclical, reflecting overall economic conditions and budgeting and buying patterns. If we are unable to remain competitive and provide value to our advertisers, they may stop placing ads with us, which would negatively harm our revenues and business.

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

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

We are subject to increased regulatory scrutiny that may negatively impact our business.

The growth of our company and our expansion into a variety of new fields implicate a variety of new regulatory issues and may subject us to increased regulatory scrutiny, particularly in the U.S. and Europe. Moreover, our competitors have employed and will likely continue to employ significant resources to shape the legal and regulatory regimes in countries where we have significant operations. Legislators and regulators may make legal and regulatory changes, or interpret and apply existing laws, in ways that make our products and services less useful to our users, require us to incur substantial costs, or change our business practices. These changes or increased costs could negatively impact our business.

A variety of new and existing U.S. and foreign laws could subject us to claims or otherwise harm our business.

We are subject to a variety of laws in the U.S. and abroad that are costly to comply with, can result in negative publicity and diversion of management time and effort, and can subject us to claims or other remedies. Many of these laws were adopted prior to the advent of the internet and related technologies and, as a result, do not contemplate or address the unique issues of the internet and related technologies. The laws that do reference the internet are being interpreted by the courts, but their applicability and scope remain uncertain. For example, the laws relating to the liability of providers of online services are currently unsettled both within the U.S. and abroad. Claims have been threatened and filed under both U.S. and foreign laws for defamation, libel, slander, invasion of privacy and other tort claims, unlawful activity, copyright and trademark infringement, or other theories based on the nature and content of the materials searched and the ads posted by our users, our products and services, or content generated by our users.

In addition, the Digital Millennium Copyright Act has provisions that limit, but do not necessarily eliminate, our liability for listing or linking to third-party websites that include materials that infringe copyrights or other rights, so long as we comply with the statutory requirements of this act. Various U.S. and international laws restrict the distribution of materials considered harmful to children and impose additional restrictions on the ability of online services to collect information

Table of Contents

from minors. In the area of data protection, many states have passed laws requiring notification to users when there is a security breach for personal data, such as California's Information Practices Act. We face similar risks and costs as our products and services are offered in international markets and may be subject to additional regulations.

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

Acquisitions are an important element of our overall corporate strategy. In particular, we expect to increase the number of acquisitions we make in 2010 compared to 2009. These transactions could be material to our financial condition and results of operations. We also expect to continue to evaluate and enter into discussions regarding a wide array of potential strategic transactions. The process of integrating an acquired company, business, or technology has created, and will continue to create, unforeseen operating difficulties and expenditures. The areas where we face risks include:

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

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

Coordination of product, engineering, and sales and marketing functions.

Transition of operations, users, and customers onto our existing platforms.

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

Retention of employees from the businesses we acquire.

Integration of the acquired company's accounting, management information, human resource, and other administrative systems.

Liability for activities of the acquired company before the acquisition, including patent and trademark infringement claims, violations of laws, commercial disputes, tax liabilities, and other known and unknown liabilities.

Litigation or other claims in connection with the acquired company, including claims from terminated employees, customers, former stockholders, or other third parties.

In the case of foreign acquisitions, the need to integrate operations across different cultures and languages and to address the particular economic, currency, political, and regulatory risks associated with specific countries.

Failure to successfully further develop the acquired technology.

Failure to obtain required approvals from governmental authorities under competition and antitrust laws on a timely basis, if it all, which could, among other things, delay or prevent us from completing a transaction, or otherwise restrict our ability to realize the

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expected financial or strategic goals of an acquisition.

Our failure to address these risks or other problems encountered in connection with our past or future acquisitions and investments could cause us to fail to realize the anticipated benefits of such acquisitions or investments, incur unanticipated liabilities, and harm our business generally.

Future acquisitions could also result in dilutive issuances of our equity securities, the incurrence of debt, contingent liabilities, or amortization expenses, or write-offs of goodwill, any of which could harm our financial condition. Also, the anticipated benefit of many of our acquisitions may not materialize. For example, we have yet to realize significant revenue benefits from our acquisition of YouTube.

Table of Contents

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

International revenues accounted for approximately 53% of our total revenues in 2009 and 52% in the first half of 2010. More than half of our user traffic came from outside the U.S. in the first half of 2010. We have limited experience with operations outside the U.S. and our ability to manage our business and conduct our operations internationally requires considerable management attention and resources and is subject to a number of risks, including the following:

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

Longer payment cycles in some countries.

Uncertainty regarding liability for services and content.

Credit risk and higher levels of payment fraud.

Currency exchange rate fluctuations and our ability to manage these fluctuations under our foreign exchange risk management program.

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

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

Potentially adverse tax consequences.

Higher costs associated with doing business internationally.

Different employee/employer relationships and the existence of workers' councils and labor unions.

In addition, compliance with complex foreign and U.S. laws and regulations that apply to our international operations increases our cost of doing business in international jurisdictions and could interfere with our ability to offer, or prevent us from offering, our products and services to one or more countries or expose us or our employees to fines and penalties. These numerous and sometimes conflicting laws and regulations include import and export requirements, content requirements, trade restrictions, tax laws, sanctions, internal and disclosure control rules, data privacy and filtering requirements, labor relations laws, U.S. laws such as the Foreign Corrupt Practices Act, and local laws prohibiting corrupt payments to governmental officials. Violations of these laws and regulations could result in fines, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business, and damage to our reputation. Although we have implemented policies and procedures designed to ensure compliance with these laws, there can be no assurance that our employees, contractors, or agents will not violate our policies. Any such violations could include prohibitions on our ability to offer our products and services to one or more countries, and could also materially damage our reputation, our brand, our international expansion efforts, our ability to attract and retain employees, our business, and our operating results.

If our security measures are breached, or if our services are subject to attacks that degrade or deny the ability of users to access our products and services, our products and services may be perceived as not being secure, users and customers may curtail or stop using our products

and services, and we may incur significant legal and financial exposure.

Our products and services involve the storage and transmission of users' and customers' proprietary information, and security breaches could expose us to a risk of loss of this information, litigation, and potential liability. Our security measures may be breached due to the actions of outside parties, employee error, malfeasance, or otherwise, and, as a result, an unauthorized party may obtain access to our data or our users' or customers' data. Additionally, outside parties may attempt to fraudulently induce employees, users, or customers to disclose sensitive information in order to gain access to our data or our users' or customers' data. Any such breach or unauthorized access could result in significant legal and financial exposure, damage to our reputation, and a loss of confidence in the security of our products and services that could potentially have an adverse effect on our business. Because the techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems change frequently and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose users and customers.

Table of Contents

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

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

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

Regulatory authorities around the world are considering a number of legislative proposals concerning data protection. In addition, the interpretation and application of data protection laws in Europe and elsewhere are still uncertain and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could have an adverse effect on our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

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

We believe our revenue growth rate will generally decline as a result of a number of factors including increasing competition, the inevitable decline in growth rates as our revenues increase to higher levels, and the increasing maturity of the online advertising market. We believe our operating margin will experience downward pressure as a result of increasing competition and increased expenditures for many aspects of our business. Our operating margin will also experience downward pressure if a greater percentage of our revenues comes from ads placed on our Google Network members' websites compared to revenues generated through ads placed on our own websites or if we spend a proportionately larger amount to promote the distribution of certain products, including Google Toolbar. The margin on revenues we generate from our Google Network members is significantly less than the margin on revenues we generate from advertising on our websites. Additionally, the margin we earn on revenues generated from our Google Network members could decrease in the future if we pay an even larger percentage of advertising fees to our Google Network members.

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

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

Our ability to continue to attract users to our websites and satisfy existing users on our websites.

Table of Contents

Our ability to monetize (or generate revenues from) traffic on our websites and our Google Network members' websites.

Our ability to attract advertisers to our AdWords program.

Our ability to attract websites to our AdSense program.

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

The amount of revenues and expenses generated and incurred in currencies other than U.S. dollars, and our ability to manage the resulting risk through our foreign exchange risk management program.

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

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

The results of our investments in risky projects.

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

Our ability to generate significant revenues from services in which we have invested considerable time and resources, such as YouTube and Google Checkout.

Because our business is