

Purchases of Equity Securities by Google

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

<u>Period</u>	<u>Total Number of Shares Purchased (1)</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs</u>
October 1 – 31	—	\$—	—	—
November 1 – 30	401	\$0.30	—	—
December 1 – 31	—	\$—	—	—
Total	401	\$0.30	—	—

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

Results of Google's Transferable Stock Option Program

Under our transferable stock option (TSO) program, which we launched in April 2007, eligible employees are able to sell vested stock options to participating financial institutions in an online auction as an alternative to exercising options in the traditional method and then selling the underlying shares. The following table provides information with respect to sales by our employees of TSOs during the three-month period ended December 31, 2007:

<u>Period (1)</u>	<u>Aggregate Amounts</u>			<u>Weighted-Average Per Share Amounts</u>		
	<u>Number of Shares Underlying TSOs Sold</u>	<u>Sale Price of TSOs Sold</u> (in thousands)	<u>TSO Premium (2)</u> (in thousands)	<u>Exercise Price of TSOs Sold</u>	<u>Sale Price of TSOs Sold</u>	<u>TSO Premium (2)</u>
October 1 – 31	216,659	\$ 92,586	\$ 5,480	\$ 262.22	\$ 427.33	\$ 25.29
November 1 – 30	167,813	\$ 68,642	\$ 6,982	\$ 330.54	\$ 409.04	\$ 41.61
December 1 – 31	—	—	—	—	—	—
Total (except weighted-average amounts)	<u>384,472</u>	<u>\$161,228</u>	<u>\$12,462</u>	\$292.04	\$419.35	\$32.41

- (1) The TSO program is generally active during regular NASDAQ trading hours when Google's trading window is open. However, we have the right to suspend the TSO program at any time for any reason, including for maintenance and other technical reasons.
- (2) TSO 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.

ITEM 6. SELECTED FINANCIAL DATA

You should read the following selected consolidated financial data in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operation” and our consolidated financial statements and the related notes appearing elsewhere in this Form 10-K.

The consolidated statements of income data for the years ended December 31, 2005, 2006 and 2007, and the consolidated balance sheet data at December 31, 2006 and 2007, are derived from our audited consolidated financial statements appearing elsewhere in this Annual Report on Form 10-K. The consolidated statements of income data for the years ended December 31, 2003 and 2004, and the consolidated balance sheet data at December 31, 2003, 2004 and 2005, are derived from our audited consolidated financial statements that are not included in this Annual Report on Form 10-K. The historical results are not necessarily indicative of the results to be expected in any future period.

	Year Ended December 31,				
	2003	2004	2005	2006	2007
	(in thousands, except per share amounts)				
Consolidated Statements of Income Data:					
Revenues	\$1,465,934	\$3,189,223	\$6,138,560	\$10,604,917	\$16,593,986
Costs and expenses:					
Cost of revenues	634,411	1,468,967	2,577,088	4,225,027	6,649,085
Research and development	229,605	395,164	599,510	1,228,589	2,119,985
Sales and marketing	164,935	295,749	468,152	849,518	1,461,266
General and administrative	94,519	188,151	386,532	751,787	1,279,250
Contribution to Google Foundation	—	—	90,000	—	—
Non-recurring portion of settlement of disputes with Yahoo	—	201,000	—	—	—
Total costs and expenses	1,123,470	2,549,031	4,121,282	7,054,921	11,509,586
Income from operations	342,464	640,192	2,017,278	3,549,996	5,084,400
Interest income and other, net	4,190	10,042	124,399	461,044	589,580
Income before income taxes	346,654	650,234	2,141,677	4,011,040	5,673,980
Provision for income taxes	241,006	251,115	676,280	933,594	1,470,260
Net income	<u>\$ 105,648</u>	<u>\$ 399,119</u>	<u>\$1,465,397</u>	<u>\$ 3,077,446</u>	<u>\$ 4,203,720</u>
Net income per share of Class A and Class B common stock					
Basic	<u>\$ 0.77</u>	<u>\$ 2.07</u>	<u>\$ 5.31</u>	<u>\$ 10.21</u>	<u>\$ 13.53</u>
Diluted	<u>\$ 0.41</u>	<u>\$ 1.46</u>	<u>\$ 5.02</u>	<u>\$ 9.94</u>	<u>\$ 13.29</u>

	As of December 31,				
	2003	2004	2005	2006	2007
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash, cash equivalents and marketable securities	\$ 334,718	\$2,132,297	\$ 8,034,247	\$11,243,914	\$14,218,613
Total assets	871,458	3,313,351	10,271,813	18,473,351	25,335,806
Total long-term liabilities	33,365	43,927	107,472	128,924	610,525
Redeemable convertible preferred stock warrant	13,871	—	—	—	—
Deferred stock-based compensation	(369,668)	(249,470)	(119,015)	—	—
Total stockholders’ equity	588,770	2,929,056	9,418,957	17,039,840	22,689,679

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements include, among other things, statements concerning our expectations:

- regarding the growth and growth rate of our operations, business, revenues, operating margins, costs and expenses;*
- that seasonal fluctuations in internet usage and traditional advertising seasonality are likely to affect our business;*
- that growth in advertising revenues from our web sites will continue to exceed that from our Google Network members' web sites;*
- regarding our future stock-based compensation charges including charges related to our TSO program;*
- that we will continue to pay most of the Google AdSense fees we receive from advertisers to our Google Network members;*
- that we may take steps to improve the relevance of the ads we deliver;*
- regarding our actions to reduce the number of accidental clicks;*
- that we will continue to make significant capital expenditure investments;*
- that the growth rate of our costs and expenses may exceed the growth rate of our revenues;*
- that our cost of revenues will increase in dollars and may increase as a percentage of revenues;*
- that traffic acquisition costs may increase as a percentage of revenues;*
- regarding the increase of research and development, sales and marketing and general and administrative expenses in the future;*
- regarding quarterly fluctuations in paid clicks;*
- that we will continue to make investments and acquisitions;*
- regarding the sufficiency of our existing cash, cash equivalents, marketable securities and cash generated from operations;*
- regarding continued investments in international markets;*
- regarding our expectations about making future donations to the Google Foundation;*

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 Annual Report on Form 10-K, and in particular, the risks discussed under the heading "Risk Factors" in Item 1A of this Annual Report on Form 10-K and those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

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

Overview

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

- *Users.* We provide users with products and services that enable people to more quickly and easily find, create and organize information that is useful to them.
- *Advertisers.* We provide advertisers with several ways to deliver relevant targeted advertising including:
 - *Google AdWords*, an auction-based advertising program that enables advertisers to deliver relevant ads targeted to search results or web content on our web site and our Google Network members' web sites.
 - *Google Audio Ads*, an automated online media platform that schedules and places advertising into radio programs.
 - *Google Print Ads*, a web-based marketplace for placing ads in print media.
 - *Google TV Ads*, an automated online media platform that schedules and places advertising into TV programs.
 - *Google Video Ads*, user-initiated click-to-play video ads that run on our web sites and the web sites of our Google Network members.

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

- *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 web sites of our Google Network members as well as programs to deliver audio ads on radio broadcasts, print ads for display in newspapers and magazines and ads on television. We share most of the fees these ads generate with our Google Network members, thereby creating an important revenue stream for them. In addition, we have entered into arrangements with certain 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 web sites and our Google Network members' web sites. 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 99% of our revenues in 2005, 2006 and 2007. We derive the balance of our revenues from the license of our web search technology, the license of our search solutions to enterprises and the sale and license of other products and services.

Google AdWords is our automated online program that enables advertisers to place targeted text-based and display ads on our web sites and the web sites of our Google Network members. 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 Google Network members' sites specified by the advertiser. For advertisers using our AdWords cost-per-click pricing, we recognize as revenue the fees charged advertisers each time a user clicks on one of the ads that appears next to the search results on our web sites or next to the search results or content on Google Network members' sites. For advertisers using our AdWords cost-per-impression pricing, we recognize as revenue the fees charged advertisers each time their ads are displayed on the Google Network members' sites. Our AdWords agreements are generally terminable at any time by our advertisers.

Google AdSense is the program through which we distribute our advertisers' AdWords ads for display on the web sites of our Google Network members. Our AdSense program includes AdSense for search and AdSense for content.

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

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

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

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

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 web sites and our Google Network members' web sites 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 and the portion of the advertiser fee we pay to our content providers as content acquisition costs under cost of revenues. In some cases, we guarantee our content providers minimum revenue share or other payments.

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 or share, and the content providers receive most of the advertiser fees generated by ads displayed on our web sites and our Google Network members' web sites.

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

listener responds to that ad. We consider the magazines and radio stations that participate in these programs to be members of our Google Network.

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

In the second quarter of 2007, we began delivering Google TV ads to viewers and helping advertisers, operators and programmers buy, schedule, deliver and measure ads on television. We recognize as revenue the fees charged advertisers each time an ad is displayed on TV in accordance with the terms of the related agreements. We consider the TV providers that participate in this program to be members of our Google Network.

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

- The relevance, objectivity and quality of our search results.
- The number and type of searches initiated at our web sites.
- The number and type of searches initiated at, as well as the number of visits to and the content of, our Google Network members' web sites.
- The advertisers' return on investment (ad cost per sale or cost per conversion) from advertising campaigns on our web sites or our Google Network members' web sites or other media compared to other forms of advertising.
- The number of advertisers and the breadth of items advertised.
- The total and per click or per impression advertising spending budgets of each advertiser.
- The amount we ultimately pay our Google Network members and our content providers for traffic and content compared to the amount of revenue we generate.
- The monetization of (or generation of revenue from) traffic on our web sites and our Google Network members' web sites.

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

- The relevance and quality of ads displayed with each search results page on our web sites and our Google Network members' web sites, as well as with each content page on our Google Network members' web sites, including the relevance and quality of an ad's "landing page" or page a user views after an ad is clicked.
- The number and prominence of ads displayed with each search results page on our web sites and our Google Network members' web sites, as well as with each content page on our Google Network members' web sites.
- The rate at which our users and users of our Google Network members' web sites click on advertisements.
- Our minimum fee per click.

We also generate revenue from the sale and license of our Search Appliance, which includes hardware, software and 12 to 24 months of post-contract support. We recognize as revenue the fee we charge customers ratably over the term of the post-contract support arrangement.

In the second quarter of 2006, we launched Google Checkout, an online shopping payment processing system for both consumers and merchants. We did not charge merchants any fees associated with the use of Google Checkout in 2007. On February 1, 2008, we began charging merchants who use Google Checkout to process sales 2% of the transaction amount plus \$0.20 per transaction to the extent these fees exceed 10 times the amount they spend on AdWords advertising. We recognize as revenue any fees charged merchants on transactions processed through Google

Checkout. Further, cash ultimately paid to merchants under Google Checkout promotions, including cash paid to merchants as a result of discounts provided to consumers on certain transactions processed through Google Checkout, is accounted for as an offset to revenues.

In the third quarter of 2007, we acquired Postini, a provider of electronic communications security, compliance, and productivity software. We recognize as revenue the fees we charge customers for hosting enterprise applications and services ratably over the terms of the service arrangements.

Trends in Our Business

Our business has grown rapidly since inception, resulting in substantially increased revenues, and we expect that our business will continue to grow. However, our revenue growth rate has generally declined over time, and we expect it will continue to do so as a result of increasing competition and the difficulty of maintaining growth rates as our revenues increase to higher levels. In addition, the main focus of our advertising programs is to provide relevant and useful advertising to our users, reflecting our commitment to constantly improve their overall web experience. As a result, we may continue to take steps to improve the relevance of the ads displayed on our web sites and our Google Network members' web sites. These steps include removing ads that generate low click-through rates or that send users to irrelevant or otherwise low quality sites and terminating Google Network members whose web sites do not meet our quality requirements. In addition, we may continue to take steps to reduce the number of accidental clicks. These steps could negatively affect our near-term advertising revenues. Both seasonal fluctuations in internet usage and traditional retail seasonality have affected, and are likely to continue to affect, our business. Internet usage generally slows during the summer months, and commercial queries typically increase significantly in the fourth quarter of each year. These seasonal trends have caused and will likely continue to cause, fluctuations in our quarterly results, including fluctuations in sequential revenue and paid click growth rates.

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

We are heavily investing in building the necessary employee and systems infrastructures required to manage our growth and develop and promote our products and services, and this may cause our operating margins to decrease. We have experienced and expect to continue to experience substantial growth in our operations as we build our research and development programs, expand our base of users, advertisers, 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. These acquisitions generally enhance the breadth and depth of our expertise in engineering and other functional areas, our technologies and our product offerings. In addition, we are incurring significant costs and expenses to support our Google Checkout product and promote its adoption by merchants and consumers, as well as promote the distribution of certain other products, including the Google Toolbar. Our headcount growth has required us to make substantial investments in property and equipment. Our full-time employee headcount has significantly increased over the last 12 months, growing from 10,674 at December 31, 2006 to 16,805 at December 31, 2007, and we also utilize a significant number of temporary employees. We also expect to continue to make significant capital expenditure investments, including information and technology infrastructure and corporate facilities. In April 2007, we launched our employee transferable stock option (TSO) program. We modified employee options to allow them to participate in this program, and as a result we incurred a modification charge of approximately \$95 million in 2007 related to vested options, and we expect to incur an additional modification charge of approximately \$134 million related to unvested options over

their remaining vesting periods through the second quarter of 2011. In addition, the fair value of each option granted under the TSO program will be greater than it would have been otherwise because of a longer expected life, resulting in more stock-based compensation per option. As a result of all of the above, the growth rate of our costs and expenses may exceed the growth rate of our revenues.

We expect our cost of revenues to continue to increase in dollars and may increase as a percentage of revenues in 2008 and in future periods, primarily as a result of forecasted increases in traffic acquisition costs, data center costs and credit card and other transaction fees, including transaction processing fees related to Google Checkout, as well as content acquisition 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 of traffic on our web sites and our Google Network members' web sites, particularly with those members to whom we have guaranteed minimum revenue share payments.

Our international revenues have grown as a percentage of our total revenues to 48% in 2007 from 43% in 2006. This increase in the portion of our revenues derived from international markets results largely from increased acceptance of our advertising programs, increases in our direct sales resources and customer support operations and our continued progress in developing localized versions of our products in these international markets.

Results of Operations

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

	<u>Year Ended December 31,</u>			<u>Three Months Ended</u>	
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>September 30,</u> <u>2007</u>	<u>December 31,</u> <u>2007</u>
	(unaudited)				
Consolidated Statement of Income Data:					
Revenues	100.0%	100.0%	100.0%	100.0%	100.0%
Costs and expenses:					
Cost of revenues	42.0	39.8	40.1	39.3	40.5
Research and development	9.8	11.6	12.8	13.0	13.1
Sales and marketing	7.6	8.0	8.8	9.0	8.8
General and administrative	6.2	7.1	7.7	7.6	7.8
Contribution to Google Foundation	1.5	—	—	—	—
Total costs and expenses	<u>67.1</u>	<u>66.5</u>	<u>69.4</u>	<u>68.9</u>	<u>70.2</u>
Income from operations	32.9	33.5	30.6	31.1	29.8
Interest income and other, net	2.0	4.3	3.6	3.6	3.5
Income before income taxes	<u>34.9</u>	<u>37.8</u>	<u>34.2</u>	<u>34.7</u>	<u>33.3</u>
Net income	<u>23.9%</u>	<u>29.0%</u>	<u>25.3%</u>	<u>25.2%</u>	<u>25.0%</u>

Revenues

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

	Year Ended December 31,			Three Months Ended	
	2005	2006	2007	September 30, 2007	December 31, 2007
				(unaudited)	
Advertising Revenues					
Google web sites	\$3,377.1	\$ 6,332.8	\$10,624.7	\$2,734.8	\$3,121.6
Google Network web sites	2,687.9	4,159.8	5,787.9	1,454.7	1,635.8
Total advertising revenues	6,065.0	10,492.6	16,412.6	4,189.5	4,757.4
Licensing and other revenues	73.6	112.3	181.4	41.9	69.3
Revenues	<u>\$6,138.6</u>	<u>\$10,604.9</u>	<u>\$16,594.0</u>	<u>\$4,231.4</u>	<u>\$4,826.7</u>

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

	Year Ended December 31,			Three Months Ended	
	2005	2006	2007	September 30, 2007	December 31, 2007
				(unaudited)	
Advertising Revenues					
Google web sites	55%	60%	64%	65%	65%
Google Network web sites	<u>44</u>	<u>39</u>	<u>35</u>	<u>34</u>	<u>34</u>
Total advertising revenues	99	99	99	99	99
Google web sites as % of advertising revenues	56	60	65	65	66
Google Network web sites as % of advertising revenues	44	40	35	35	34
Licensing and other revenues	1%	1%	1%	1%	1%

Growth in our revenues from 2006 to 2007 and from 2005 to 2006, as well as from the three months ended September 30, 2007 to the three months ended December 31, 2007 resulted primarily from growth in advertising revenues for Google web sites and Google Network web sites. Our advertising revenue growth for Google web sites and Google Network web sites resulted primarily from an increase in the total number of paid clicks and ads displayed through our programs, rather than from changes in the average fees paid by our advertisers. The increase in the number of paid clicks and ads displayed through our programs was due to an increase in aggregate traffic both on our web sites and those of our Google Network members, certain monetization improvements and the continued global expansion of our products, our advertiser base and our user base. Improvements in our ability to monetize this 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' sites they visit. These improvements included, for instance, enhancements to the accuracy of our quality scoring, which is our measurement of an ad's quality, a change in the background color from blue to yellow for certain ads displayed on our search results pages, a change to the formula used to determine which ads appear at the top of our search results pages, a change to consider not only a user's current search query, but also their immediately preceding query, to determine the ads displayed on our search results pages, as well as a change to the clickable area around our AdSense for content text-based ads to only the title and URL to reduce the number of accidental clicks.

The sequential quarterly revenue growth rate from our web sites increased from 10.0% for the three months ended September 30, 2007, to 14.1% for the three months ended December 31, 2007. This increase is primarily the result of increased traffic, substantially due to seasonality, and to a lesser extent, improvements in our ability to monetize traffic on our web sites, as well as the continued global expansion of our products, our advertiser base and our user base. The

sequential quarterly revenue growth rate from our Google Network members' web sites increased from 7.6% for the three months ended September 30, 2007, to 12.5% for the three months ended December 31, 2007. This increase is primarily the result of increased traffic of certain core partners, substantially due to seasonality, as well as the continued global expansion of our advertiser base and partner network, partially offset by an improvement to AdSense for content text-based ads which reduced the number of accidental clicks (see above). The sequential quarterly revenue growth from our web sites was greater than that from our Google Network members' web sites primarily as a result of a greater increase in the total number of paid clicks on our web sites, which was largely due to higher traffic growth and monetization improvements. We expect that our revenue growth rates will generally decline in the future as a result of increasing competition and the difficulty of maintaining growth rates as our revenues increase to higher levels.

Aggregate paid clicks on our web sites and our Google Network members' web sites increased approximately 9% from the three months ended September 30, 2007 to the three months ended December 31, 2007, approximately 43% from the year ended 2006 to the year ended 2007 and approximately 65% from the year ended 2005 to the year ended 2006. In general, the increase in paid clicks has historically correlated with increases in our revenues. However, the rate of increase in paid clicks, and its correlation with the rate of increase in revenues, may fluctuate from quarter to quarter based on various factors including seasonality, advertiser competition for keywords and the revenue growth rates on our web sites compared to those of our Google Network members. In addition, traffic growth in emerging markets compared to more mature markets and across various advertising verticals also contributes to these fluctuations.

We believe that the increase in the number of paid clicks and ads displayed through our programs is 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 realized through the Google Print Ads Program, Google Audio Ads, Google TV Ads, Google Checkout, YouTube, Postini and Search Appliance were not material in any of the periods presented.

Revenues by Geography

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

	Year Ended December 31,			Three Months Ended	
	2005	2006	2007	September 30, 2007	December 31, 2007
				(unaudited)	
United States	61%	57%	52%	52%	52%
United Kingdom	14%	15%	15%	16%	14%
Rest of the world	25%	28%	33%	32%	34%

The decrease in the United Kingdom revenues as a percentage of total revenues from the three months ended September 30, 2007 to the three months ended December 31, 2007 is primarily a result of seasonal slowdown in certain advertising verticals, such as finance and travel.

The yearly growth in international revenues resulted largely from increased acceptance of our advertising programs and increases in our direct sales resources and customer support operations in international markets and our continued progress in developing localized versions of our products for these international markets.

In addition, the weakening of the U.S. dollar relative to other foreign currencies (primarily the euro and the British pound) in the three and twelve months ended December 31, 2007 compared to the three months ended September 30, 2007 and the twelve months ended December 31, 2006 had a favorable impact on our international revenues, which increased \$295.2 million and \$3,321.2 million. Had foreign exchange rates remained constant in these periods, our total revenues would have been approximately \$93.6 million and \$542.0 million, or 1.9% and 3.3%, lower.

While international revenues in each of the periods presented accounted for less than half of our total revenues, more than half of our user traffic during these periods came from outside the U.S. Although we expect to continue to make investments in international markets, they may not result in an increase in our international revenues as a percentage of total revenues in 2008 or thereafter. See Note 14 of Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for additional information about geographic areas.

Costs and Expenses

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

In addition, certain AdSense agreements obligate us to make guaranteed minimum revenue share payments to Google Network members based on their achieving defined performance terms, such as number of search queries or advertisements displayed. To the extent we expect revenues generated under such an arrangement to exceed the guaranteed minimum revenue share payments, we recognize traffic acquisition costs on a contractual revenue share or on a basis proportionate to forecasted revenues, whichever is greater. Otherwise, we recognize the guaranteed revenue share payments as traffic acquisition costs on a straight-line basis over the term of the related agreements. In addition, concurrent with the commencement of a small number of AdSense and other agreements, we have purchased certain items from, or provided other consideration to, our Google Network members and partners. We have determined that certain of these amounts are prepaid traffic acquisition costs and are amortized on a straight-line basis over the terms of the related agreements.

Cost of revenues also includes the expenses associated with the operation of our data centers, including depreciation, labor, energy and bandwidth costs, credit card and other transaction fees related to processing customer transactions as well as content acquisition costs. We have entered into arrangements with certain 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 web sites and our Google Network members’ web sites 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 greater of the following three amounts: the contractual revenue share amount, if any, based on the number of times the content is displayed, or on a straight-line basis over the terms of the agreements. The following tables present our cost of revenues and cost of revenues as a percentage of revenues, and our traffic acquisition costs and traffic acquisition costs as a percentage of advertising revenues for the periods presented (dollars in millions):

	Year Ended December 31,			Three Months Ended	
	2005	2006	2007	September 30, 2007	December 31, 2007
				(unaudited)	
Cost of revenues	\$2,577.1	\$4,225.0	\$6,649.1	\$1,662.6	\$1,955.8
Cost of revenues as a percentage of revenues	42.0%	39.8%	40.1%	39.3%	40.5%
				(unaudited)	
				(unaudited)	
				(unaudited)	
Traffic acquisition costs	\$2,114.9	\$3,308.8	\$4,933.9	\$1,221.1	\$1,439.8
Traffic acquisition costs as a percentage of advertising revenues	34.9%	31.5%	30.1%	29.1%	30.3%

Cost of revenues increased \$293.2 million from the three months ended September 30, 2007 to the three months ended December 31, 2007. There was an increase in traffic acquisition costs of \$218.7 million which includes an increase of \$20.0 million in fees related to distribution arrangements. Over this same period there was an increase in data center costs of \$60.6 million primarily as a result of the depreciation of additional information technology assets and data center buildings as well as additional personnel required to manage the data centers. In addition, there was an increase in credit card and other transaction processing fees of \$8.3 million resulting from more advertiser fees generated through AdWords as well as more transaction processing fees related to Google Checkout. The traffic acquisition costs associated with revenues generated from ads placed on our web sites is considerably lower than the traffic acquisition costs associated with revenues generated from ads placed on our Google Network members' web sites. The increase in cost of revenues as a percentage of revenues, as well as traffic acquisition costs as a percentage of advertising revenues, was primarily related to the performance of a few Google Network member web sites for which we are required to make guaranteed payments, including social networking traffic, which is not monetizing as well as expected. This more than offset the increase in the proportion of advertising revenues coming from our web sites rather than from our Google Network members' web sites.

Cost of revenues increased \$2,424.1 million from 2006 to 2007. This increase was primarily the result of additional traffic acquisition costs, the depreciation of additional information technology assets purchased in the current and prior periods, other additional data center costs and additional credit card and other transaction fees. There was an increase in traffic acquisition costs of \$1,625.1 million which includes an increase of \$216.7 million in fees related to distribution arrangements. Over this same period there was an increase in data center costs of \$565.2 million primarily resulting from the depreciation of additional information technology assets as well as additional labor required to manage the data centers. In addition, there was an increase in expenses related to acquiring content on our web sites of \$80.7 million, an increase in the amortization of developed technology of \$56.0 million resulting from acquisitions in the current and prior years and an increase in credit card and other transaction processing fees of \$44.5 million resulting from more advertiser fees being generated through AdWords as well as transaction processing fees related to Google Checkout in 2007. The increase in cost of revenues as a percentage of revenues was primarily the result of the depreciation of additional information technology assets purchased in the current and prior periods and other additional data center costs as well as the increased expenses related to acquiring content on our web sites, which more than offset the proportionately greater revenues from our web sites compared to our Google Network members' web sites. The decrease in traffic acquisition costs as a percentage of advertising revenues was primarily the result of proportionately greater revenues from our web sites compared to our Google Network members' web sites, partially offset by the factors discussed in the paragraph above.

Cost of revenues increased \$1,647.9 million from 2005 to 2006. There was an increase in traffic acquisition costs of \$1,193.9 million which includes an increase of \$84.1 million in fees expensed related to distribution arrangements. Over this same period there was an increase in data center costs of \$307.9 million primarily resulting from the depreciation of additional information technology assets purchased in the current and prior periods as well as additional labor required to manage the data centers. In addition, there was an increase in credit card and other transaction processing fees of \$58.4 million resulting from more advertiser fees being generated through AdWords as well as transaction processing fees related to Google Checkout in 2006, an increase in expenses related to acquiring content on our web sites of \$23.0 million, an increase in the amortization of developed technology of \$21.6 million resulting from acquisitions in the current and prior years as well as an increase in Search Appliance costs of \$10.8 million. The decrease in cost of revenues as a percentage of revenues, as well as traffic acquisition costs as a percentage of advertising revenues, was primarily the result of proportionately greater revenues from our web sites compared to our Google Network members' web sites.

We expect cost of revenues to continue to increase in dollars and may increase as a percentage of revenues in 2008 and in future periods, primarily as a result of increases in traffic acquisition costs, data center costs, credit card and other transaction fees, including transaction processing fees related to Google Checkout, content acquisition costs and other costs. Traffic acquisition costs as a percentage of advertising revenues may fluctuate in the future based on a number of factors, including:

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

- whether we are able to enter into more AdSense arrangements that provide for lower revenue share obligations or whether increased competition for arrangements with existing and potential Google Network members results in less favorable revenue share arrangements.
- whether we are able to continue to improve the monetization of traffic on our web sites and our Google Network members' web sites, particularly with those members to whom we have guaranteed minimum revenue share payments.
- whether we share with existing and new partners proportionately more of the aggregate advertising fees that we earn from paid clicks derived from search queries these partners direct to our web sites.
- the relative growth rates of expenses associated with distribution arrangements and the related revenues generated.

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

	Year Ended December 31,			Three Months Ended	
	2005	2006	2007	September 30, 2007	December 31, 2007
Research and development expenses	\$599.5	\$1,228.6	\$2,120.0	\$548.7	\$630.8
Research and development expenses as a percentage of revenues	9.8%	11.6%	12.8%	13.0%	13.1%

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

Research and development expenses increased \$82.1 million from the three months ended September 30, 2007 to the three months ended December 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$74.0 million as a result of a 7% increase in research and development headcount including an increase in stock-based compensation expense of \$30.7 million.

Research and development expenses increased \$891.4 million from the year ended December 31, 2006 to the year ended December 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$708.0 million as a result of a 57% increase in research and development headcount, including an increase in stock-based compensation expense of \$282.3 million. In addition, there was an increase in depreciation and related expenses of \$72.3 million due to our increased capital expenditure.

Research and development expenses increased \$629.1 million from the year ended December 31, 2005 to the year ended December 31, 2006, primarily due to an increase in labor and facilities related costs of \$514.5 million as a result of a 77% increase in research and development headcount, including an increase in stock-based compensation cost of \$172.0 million. In addition, there was an increase in depreciation and related expenses of \$53.4 million primarily as a result of increasing dollar amounts of information technology assets purchased during 2005 and 2006, as well as an increase in the amortization of developed technology acquired in 2006 and prior years of \$12.4 million.

We anticipate that research and development expenses will increase in dollar amount and may increase as a percentage of revenues in 2008 and future periods because we expect to hire more research and development personnel and build the infrastructure required to support the development of new, and improve existing, products and services. In addition, we expect to recognize greater stock-based compensation on a per option basis as a result of our employee transferable stock option (TSO) program.

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):

	<u>Year Ended December 31,</u>			<u>Three Months Ended</u>	
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>September 30,</u> <u>2007</u>	<u>December 31,</u> <u>2007</u>
Sales and marketing expenses	\$468.2	\$849.5	\$1,461.3	\$380.8	\$422.3
Sales and marketing expenses as a percentage of revenues	7.6%	8.0%	8.8%	9.0%	8.8%

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

Sales and marketing expenses increased \$41.5 million from the three months ended September 30, 2007 to the three months ended December 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$43.6 million mostly as a result of an increase in certain bonuses and a 3% increase in sales and marketing headcount, including an increase in stock-based compensation expense of \$8.2 million, partially offset by a decrease in advertising and promotional expense of \$3.9 million.

Sales and marketing expenses increased \$611.8 million from the year ended December 31, 2006 to the year ended December 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$435.7 million mostly as a result of a 52% increase in sales and marketing headcount, including an increase in stock-based compensation expense of \$72.2 million, and an increase in depreciation and related expense of \$74.2 million due to our increased capital expenditures. In addition, there was an increase in promotional and advertising expense of \$37.5 million and an increase in travel and entertainment expense of \$28.9 million.

Sales and marketing expenses increased \$381.3 million from the year ended December 31, 2005 to the year ended December 31, 2006. This increase was primarily due to an increase in labor and facilities related costs of \$240.1 million mostly as a result of an 88% increase in sales and marketing headcount, including an increase in stock-based compensation of \$31.0 million, an increase in promotional and advertising expenses of \$83.5 million and an increase in depreciation and related expenses of \$21.6 million.

We anticipate sales and marketing expenses will continue to increase in dollar amount and may increase as a percentage of revenues in 2008 and future periods as we continue to expand our business on a worldwide basis. A significant portion of these increases relate to our plan to hire additional personnel and increase advertising and promotional expenditures to increase the level of service we provide to our advertisers and Google Network members. We also plan to add a significant number of international sales personnel to support our worldwide expansion. In addition, we expect greater stock-based compensation expenses on a per option basis as a result of our TSO program.

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):

	<u>Year Ended December 31,</u>			<u>Three Months Ended</u>	
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>September 30,</u> <u>2007</u>	<u>December 31,</u> <u>2007</u>
General and administrative expenses	\$386.5	\$751.8	\$1,279.3	\$321.4	\$377.0
General and administrative expenses as a percentage of revenues	6.2%	7.1%	7.7%	7.6%	7.8%

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

General and administrative expenses increased \$55.6 million from the three months ended September 30, 2007 to the three months ended December 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$24.9 million primarily as a result of a 6% increase in general and administrative headcount, including an increase in stock-based compensation expense of \$6.2 million, an increase in professional services of \$15.9 million and an increase in charitable contributions of \$7.3 million.

General and administrative expenses increased \$527.5 million from the year ended December 31, 2006 to the year ended December 31, 2007. This increase was primarily due to an increase in labor and facilities related costs of \$306.4 million, primarily as a result of a 72% increase in general and administrative headcount from 2006 to 2007, including an increase in stock-based compensation expense of \$51.3 million and an increase in professional services fees of \$95.1 million. In addition, there was an increase in bad debt expense of \$35.6 million. The additional personnel, professional services and bad debt expenses are primarily the result of the growth of our business.

General and administrative expenses increased \$365.3 million from the year ended December 31, 2005 to the year ended December 31, 2006. This increase was primarily due to an increase in labor and facilities related costs of \$192.7 million, primarily as a result of a 92% increase in headcount from 2005 to 2006, including an increase in stock-based compensation expense of \$42.4 million, an increase in professional services fees of \$76.3 million and an increase in depreciation and related costs of \$43.4 million. We also recognized \$30.0 million in plaintiffs' attorneys' expenses related to the settlement of the Lane's Gift class action lawsuit recognized in 2006. The additional personnel, professional services and depreciation expenses are primarily the result of the growth of our business.

As we expand our business and incur additional expenses, we believe general and administrative expenses will increase in dollar amount and may increase as a percentage of revenues in 2008 and future periods. In addition, we expect greater stock-based compensation expenses on a per option basis as a result of our TSO program.

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

	Year Ended December 31,			Three Months Ended	
	2005	2006	2007	September 30, 2007	December 31, 2007
				(unaudited)	
Stock-based compensation	\$200.7	\$458.1	\$868.6	\$198.0	\$245.3
Stock-based compensation as a percentage of revenues ...	3.3%	4.3%	5.2%	4.7%	5.1%

Prior to January 1, 2006, we accounted for employee stock-based compensation using the intrinsic value method under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"). Under APB 25, deferred stock-based compensation for options granted to employees is equal to its intrinsic value, determined as the difference between the exercise prices and the values of the underlying stock on the dates of grant.

Prior to our initial public offering we typically granted stock options at exercise prices equal to or less than the value of the underlying stock as determined by our board of directors on the date of option grant. For purposes of financial accounting, we applied hindsight within each year or quarter prior to our initial public offering to arrive at reassessed values for the shares underlying these options. We recognized the difference between the exercise prices and the reassessed values as stock-based compensation over the vesting periods on an accelerated basis.

After the initial public offering, we have generally granted options at exercise prices equal to the fair market value of the underlying stock on the dates of option grant. As a result, only an immaterial amount of stock-based compensation was recognized over the vesting periods on an accelerated basis.

In the fourth quarter of 2004, we began granting restricted stock units ("RSUs") to certain employees under our Founders' Award and other programs (see Note 11 of Notes to Consolidated Financial Statements included as part of this