

Google Inc.
CONSOLIDATED BALANCE SHEETS
(In thousands, except par value per share)

	As of December 31,	
	2006	2007
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,544,671	\$ 6,081,593
Marketable securities	7,699,243	8,137,020
Accounts receivable, net of allowance of \$16,914 and \$32,887	1,322,340	2,162,521
Deferred income taxes, net	29,713	68,538
Income taxes receivable	—	145,253
Prepaid revenue share, expenses and other assets	443,880	694,213
Total current assets	13,039,847	17,289,138
Prepaid revenue share, expenses and other assets, non-current	114,455	168,530
Deferred income taxes, net, non-current	—	33,219
Non-marketable equity securities	1,031,850	1,059,694
Property and equipment, net	2,395,239	4,039,261
Intangible assets, net	346,841	446,596
Goodwill	1,545,119	2,299,368
Total assets	<u>\$18,473,351</u>	<u>\$25,335,806</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 211,169	\$ 282,106
Accrued compensation and benefits	351,671	588,390
Accrued expenses and other current liabilities	266,247	465,032
Accrued revenue share	370,364	522,001
Deferred revenue	105,136	178,073
Total current liabilities	1,304,587	2,035,602
Deferred revenue, long-term	20,006	30,249
Deferred income taxes, net	40,421	—
Income taxes payable, long-term	—	478,372
Other long-term liabilities	68,497	101,904
Commitments and contingencies		
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, \$0.001 par value per share: 9,000,000 shares authorized; 308,997 (Class A 227,670, Class B 81,327) and par value of \$309 (Class A \$228, Class B \$81) and 312,917 (Class A 236,097, Class B 76,820) and par value of \$313 (Class A \$236, Class B \$77) shares issued and outstanding, excluding 1,296 (Class A 1,045 Class B 251) and 361 (Class A 336, Class B 25) shares subject to repurchase (see Note 11) at December 31, 2006 and 2007	309	313
Additional paid-in capital	11,882,906	13,241,221
Accumulated other comprehensive income	23,311	113,373
Retained earnings	5,133,314	9,334,772
Total stockholders' equity	17,039,840	22,689,679
Total liabilities and stockholders' equity	<u>\$18,473,351</u>	<u>\$25,335,806</u>

See accompanying notes.

Google Inc.

CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)

	Year Ended December 31,		
	2005	2006	2007
Revenues	\$6,138,560	\$10,604,917	\$16,593,986
Costs and expenses:			
Cost of revenues (including stock-based compensation expense of \$5,579, \$17,629, \$22,335)	2,577,088	4,225,027	6,649,085
Research and development (including stock-based compensation expense of \$115,532, \$287,485, \$569,797)	599,510	1,228,589	2,119,985
Sales and marketing (including stock-based compensation expense of \$28,411, \$59,389, \$131,638)	468,152	849,518	1,461,266
General and administrative (including stock-based compensation expense of \$51,187, \$93,597, \$144,876)	386,532	751,787	1,279,250
Contribution to Google Foundation	90,000	----	----
Total costs and expenses	4,121,282	7,054,921	11,509,586
Income from operations	2,017,278	3,549,996	5,084,400
Interest income and other, net	124,399	461,044	589,580
Income before income taxes	2,141,677	4,011,040	5,673,980
Provision for income taxes	676,280	933,594	1,470,260
Net income	<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>\$ 5.31</u>	<u>\$ 10.21</u>	<u>\$ 13.53</u>
Diluted	<u>\$ 5.02</u>	<u>\$ 9.94</u>	<u>\$ 13.29</u>

See accompanying notes.

Google Inc.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	Class A and Class B Common Stock		Additional Paid-In Capital Amount	Deferred Stock Based Compensation	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders' Equity
	Shares	Amount					
Balance at January 1, 2005	266,917	\$ 267	\$ 2,582,352	\$(249,470)	\$ 5,436	\$ 590,471	\$ 2,929,056
Issuance of common stock in connection with follow-on public offering and acquisitions, net	14,869	15	4,316,022	(2,036)	—	—	4,314,001
Stock-based award activity	11,241	11	579,418	132,491	—	—	711,920
Comprehensive income:							
Change in unrealized gain (loss) on available-for-sale investments, net of tax effect of \$11,404	—	—	—	—	16,580	—	16,580
Foreign currency translation adjustment	—	—	—	—	(17,997)	—	(17,997)
Net income	—	—	—	—	—	1,465,397	1,465,397
Total comprehensive income	—	—	—	—	—	—	1,463,980
Balance at December 31, 2005	293,027	293	7,477,792	(119,015)	4,019	2,055,868	9,418,957
Issuance of common stock in connection with follow-on public offering and acquisitions, net	7,689	8	3,236,778	—	—	—	3,236,786
Stock-based award activity	8,281	8	1,168,336	119,015	—	—	1,287,359
Comprehensive income:							
Change in unrealized gain (loss) on available-for-sale investments, net of tax effect of \$13,280	—	—	—	—	(19,309)	—	(19,309)
Foreign currency translation adjustment	—	—	—	—	38,601	—	38,601
Net income	—	—	—	—	—	3,077,446	3,077,446
Total comprehensive income	—	—	—	—	—	—	3,096,738
Balance at December 31, 2006	308,997	309	11,882,906	—	23,311	5,133,314	17,039,840
Stock-based award activity	3,920	4	1,358,315	—	—	—	1,358,319
Comprehensive income:							
Change in unrealized gain (loss) on available-for-sale investments, net of tax effect of \$19,963	—	—	—	—	29,029	—	29,029
Foreign currency translation adjustment	—	—	—	—	61,033	—	61,033
Net income	—	—	—	—	—	4,203,720	4,203,720
Total comprehensive income	—	—	—	—	—	—	4,293,782
Adjustment to retained earnings upon adoption of FIN 48	—	—	—	—	—	(2,262)	(2,262)
Balance at December 31, 2007	312,917	\$ 313	\$13,241,221	\$ —	\$113,373	\$9,334,772	\$22,689,679

See accompanying notes.

Google Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31,		
	2005	2006	2007
Operating activities			
Net income	\$ 1,465,397	\$ 3,077,446	\$ 4,203,720
Adjustments:			
Depreciation and amortization of property and equipment	256,812	494,430	807,743
Amortization of intangibles and other	37,000	77,509	159,915
Stock-based compensation	200,709	458,100	868,646
Excess tax benefits from stock-based award activity	433,724	(581,732)	(379,206)
Deferred income taxes	21,163	(98,468)	(164,212)
Other, net	22,040	12,474	(39,741)
Changes in assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(372,290)	(624,012)	(837,247)
Income taxes, net	66,237	496,882	744,802
Prepaid revenue share, expenses and other assets	(51,663)	(289,157)	(298,689)
Accounts payable	80,631	95,402	70,135
Accrued expenses and other liabilities	166,764	291,533	418,905
Accrued revenue share	93,347	139,300	150,310
Deferred revenue	39,551	30,801	70,329
Net cash provided by operating activities	<u>2,459,422</u>	<u>3,580,508</u>	<u>5,775,410</u>
Investing activities			
Purchases of property and equipment	(838,217)	(1,902,798)	(2,402,840)
Purchase of marketable securities	(12,675,880)	(26,681,891)	(15,997,060)
Maturities and sales of marketable securities	10,257,214	23,107,132	15,659,473
Investments in non-marketable equity securities	—	(1,019,147)	(34,511)
Acquisitions, net of cash acquired and purchases of intangible and other assets	(101,310)	(402,446)	(906,651)
Net cash used in investing activities	<u>(3,358,193)</u>	<u>(6,899,150)</u>	<u>(3,681,589)</u>
Financing activities			
Net proceeds from stock-based award activity	85,026	321,117	23,861
Excess tax benefits from stock-based award activity	—	581,732	379,206
Net proceeds from public offerings	4,287,229	2,063,549	—
Payments of principal on capital leases and equipment loans	(1,425)	—	—
Net cash provided by financing activities	<u>4,370,830</u>	<u>2,966,398</u>	<u>403,067</u>
Effect of exchange rate changes on cash and cash equivalents	(21,758)	19,741	40,034
Net increase (decrease) in cash and cash equivalents	3,450,301	(332,503)	2,536,922
Cash and cash equivalents at beginning of year	426,873	3,877,174	3,544,671
Cash and cash equivalents at end of year	<u>\$ 3,877,174</u>	<u>\$ 3,544,671</u>	<u>\$ 6,081,593</u>
Supplemental disclosures of cash flow information			
Cash paid for interest	<u>\$ 216</u>	<u>\$ 257</u>	<u>\$ 1,336</u>
Cash paid for taxes	<u>\$ 153,628</u>	<u>\$ 537,702</u>	<u>\$ 882,688</u>
Acquisition related activities:			
Issuance of equity in connection with acquisitions, net	<u>\$ 22,407</u>	<u>\$ 1,173,234</u>	<u>\$ —</u>

See accompanying notes.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 intranet solutions via an enterprise search appliance.

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.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the amounts reported and disclosed in the financial statements and the accompanying notes. Actual results could differ materially from these estimates. On an ongoing basis, we evaluate our estimates, including those related to the accounts receivable and sales allowances, fair values of marketable and non-marketable securities, fair values of prepaid revenue share, intangible assets and goodwill, useful lives of intangible assets, property and equipment, fair values of options to purchase our common stock, and income taxes, among others. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Revenue Recognition

The following table presents our revenues:

	Year Ended December 31,		
	2005	2006	2007
	(in thousands)		
Advertising revenues:			
Google web sites	\$3,377,060	\$ 6,332,797	\$10,624,705
Google Network web sites	2,687,942	4,159,831	5,787,938
Total advertising revenues	6,065,002	10,492,628	16,412,643
Licensing and other revenues	73,558	112,289	181,343
Revenues	<u>\$6,138,560</u>	<u>\$10,604,917</u>	<u>\$16,593,986</u>

In the first quarter of 2000, we introduced our first advertising program through which we offered advertisers the ability to place text-based ads on Google web sites targeted to users' search queries. Advertisers paid us based on the number of times their ads were displayed on users' search results pages, and we recognized revenue at the time these ads appeared. In the fourth quarter of 2000, we launched Google AdWords, an online self-service program that enables advertisers to place text-based ads on Google web sites. Ad Words is also available through our direct sales force. AdWords advertisers originally paid us based on the number of times their ads appeared on users' search results pages. In the first quarter of 2002, we began offering AdWords on a cost-per-click basis, so that an advertiser pays us only when a user clicks on one of its ads. From January 1, 2004, until the end of the first quarter of 2005, the AdWords cost-per-click pricing structure was the only structure available to our advertisers. However, during the second quarter of 2005, we launched an AdWords program that enables advertisers to pay us based on the number of times their ads appear on Google Network member sites specified by the advertiser.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Google AdSense is the program through which we distribute our advertisers' ads for display on the web sites of our Google Network members.

We recognize as revenues the fees charged advertisers each time a user clicks on one of the text-based ads that are displayed next to the search results pages on our site or on the search results pages or content pages of our Google Network members' web sites and, for those advertisers who use our cost-per impression pricing, the fees charged advertisers each time an ad is displayed on our members' sites. In addition, we recognize as revenues the fees charged advertisers when ads are published in the magazines or broadcasted by the radio stations (or each time a listener responds to that ad) of our Google Network members. We recognize these revenues as such because the services have been provided, and the other criteria set forth under Staff Accounting Bulletin Topic 13: *Revenue Recognition* have been met, namely, the fees we charge are fixed or determinable, we and our advertisers understand the specific nature and terms of the agreed-upon transactions and collectibility is reasonably assured. In accordance with Emerging Issues Task Force ("EITF") Issue No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent* ("EITF 99-19"), we report our Google AdSense revenues on a gross basis principally because we are the primary obligor to our advertisers.

In the third quarter of 2005, we launched the 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 second quarter of 2006, we launched Google Checkout, an online shopping payment processing system for both consumers and merchants. We recognize as revenues 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, are accounted for as an offset to revenues in accordance with EITF Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*.

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 announced our trial to deliver Google TV ads to viewers and help 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.

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 term of the service arrangement.

Revenues realized through the Google Print Ads Program, Google Audio Ads, Google TV Ads, Google Checkout, YouTube and Postini were not material in any of the years presented.

We generate fees from search services on a per-query basis. Our policy is to recognize revenues from per-query search fees in the period we provide the search results.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Deferred revenue is recorded when payments are received in advance of our performance in the underlying agreement on the accompanying Consolidated Balance Sheets.

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 charged to expense 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, 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 basis 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. Traffic acquisition costs were \$2,114.9 million, \$3,308.8 million and \$4,933.9 million in 2005, 2006 and 2007.

Prepaid revenue share and distribution fees are included in prepaid revenue share, expenses and other assets on the accompanying Consolidated Balance Sheets.

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

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock-based Compensation

Prior to January 1, 2006, we accounted for employee stock-based compensation using the intrinsic value method supplemented by pro forma disclosures in accordance with Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25”) and Statement of Financial Accounting Standards (“SFAS”) No. 123, *Accounting for Stock-Based Compensation* (“SFAS 123”), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* (“SFAS 148”). Effective January 1, 2006, we adopted SFAS No. 123R, *Share-Based Payment* (“SFAS 123R”) using the modified prospective approach and accordingly prior periods have not been restated to reflect the impact of SFAS 123R.

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

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

In compliance with SFAS 123R, we included as part of cash flows from financing activities the benefits of tax deductions in excess of the tax-effected compensation of the related stock-based awards for the options exercised and RSUs vested during the years ended December 31, 2006 and 2007, whereas the excess tax benefits previously generated in 2005 under the then applicable accounting rules, are reported as a cash flow from operating activities. Total cash flow remains unchanged from what would have been reported under prior accounting rules. During the year ended December 31, 2007, the amount of cash received from exercise of stock options was \$137.2 million and the total direct tax benefit realized, including the excess tax benefit, from stock based award activity was \$463.2 million. We have elected to account for the indirect effects of stock-based awards—primarily the research and development tax credit—through the income statement.

We account for stock awards issued to non-employees other than members of our board of directors in accordance with the provisions of SFAS 123R and EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* (“EITF 96-18”). Under SFAS 123R and EITF 96-18, we use the BSM method to measure the value of options granted to non-employees at each vesting date to determine the appropriate charge to stock-based compensation.

In the years ended December 31, 2006 and 2007, we recognized stock-based compensation and related tax benefits of \$458.1 million and \$108.9 million, and \$868.6 million and \$143.0 million respectively.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Prior to the adoption of SFAS 123R, we accounted for our employee stock-based compensation using the intrinsic value method prescribed by APB 25. We applied below the disclosure provisions of SFAS 123, as amended by SFAS No. 148, as if the fair value method had been applied. If this method had been used, our net income and net income per share for the years ended December 31, 2005 would have been adjusted to the pro forma amounts below (in thousands, except per share amounts):

	Year Ended December 31, 2005
Net income, as reported	\$1,465,397
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	117,924
Deduct: Total stock-based employee compensation expense under the fair value based method for all awards, net of related tax effects	(220,525)
Net income, pro forma	<u>\$1,362,796</u>
Net income per share:	
As reported for prior period—basic	\$ 5.31
Pro forma—basic	\$ 4.94
As reported for prior period—diluted	\$ 5.02
Pro forma—diluted	\$ 4.67

For purposes of the above pro forma calculation, the value of each option granted through December 31, 2005 was estimated on the date of grant using the BSM pricing model with the following weighted-average assumptions.

	Year Ended December 31, 2005
Risk-free interest rate	3.86%
Expected volatility	36%
Expected life (in years)	3.1
Dividend yield	---
Weighted-average estimated fair value of options granted during the year	\$78.58

Stock Options Exercised Prior to Vesting

Options granted under plans other than the 2004 Stock Plan may be exercised prior to vesting. Upon the exercise of an option prior to vesting, the exercising optionee is required to enter into a restricted stock purchase agreement with us, which provides that we have a right to repurchase the shares purchased upon exercise of the option at the original exercise price; provided, however, that our right to repurchase these shares will lapse in accordance with the vesting schedule included in the optionee's option agreement. In accordance with EITF 00-23, *Issues Related to Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44* ("EITF 00-23"), stock options granted or modified after March 21, 2002, which are subsequently exercised for cash prior to vesting are treated differently from prior grants and related exercises. The consideration received for an exercise of an option granted after the effective date of this guidance is considered to be a deposit of the exercise price and the related dollar amount is recorded as a liability. The shares and liability are only reclassified into equity on a ratable basis as the award vests. We have applied this guidance and recorded a liability on the Consolidated Balance Sheets relating to 1,296,155 and 360,679 of options granted subsequent to March 21, 2002 that were exercised and are unvested at December 31, 2006 and 2007. Furthermore, these shares are not presented as outstanding on the accompanying Consolidated Statements of Stockholders' Equity and Consolidated Balance Sheets. Instead, these shares are disclosed as outstanding options in Note 11 to these financial statements.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Certain Risks and Concentrations

Our revenues are principally derived from online advertising, the market for which is highly competitive and rapidly changing. Significant changes in this industry or changes in customer buying behavior could adversely affect our operating results.

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents, marketable securities and accounts receivable. Cash equivalents and marketable securities consist primarily of money market funds and highly liquid debt instruments of municipalities in the U.S. and the U.S. government and its agencies. Accounts receivable are typically unsecured and are derived from revenues earned from customers primarily located in the U.S. In 2005, 2006 and 2007, we generated approximately 61%, 57% and 52% of our revenues from customers based in the U.S. with the majority of customers outside of the U.S. located in Europe and Japan. Many of our Google Network members are in the internet industry. We perform ongoing evaluations to determine customer credit and limit the amount of credit extended, but generally no collateral is required. We maintain reserves for estimated credit losses and these losses have generally been within our expectations.

No advertiser or Google Network member generated greater than 10% of revenues in 2005, 2006 and 2007.

Fair Value of Financial Instruments

The carrying amounts of our financial instruments, including cash and cash equivalents, marketable securities, accounts receivable, accounts payable and accrued liabilities, approximate fair value because of their generally short maturities.

Cash and Cash Equivalents and Marketable Securities

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

We determine the appropriate classification of our investments in marketable securities at the time of purchase and reevaluate such designation at each balance sheet date. Our marketable securities have been classified and accounted for as available-for-sale. We may or may not hold securities with stated maturities greater than 12 months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, we occasionally sell these securities prior to their stated maturities. As these securities are viewed by us as available to support current operations, based on the provisions of Accounting Research Bulletin No. 43, Chapter 3A, *Working Capital—Current Assets and Liabilities*, securities with maturities beyond 12 months (such as our auction rate securities) are classified as current assets under the caption marketable securities in the accompanying Consolidated Balance Sheets. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity, except for unrealized losses determined to be other than temporary which are recorded as interest income and other, net, in accordance with our policy and FASB Staff Position ("FSP") Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of interest income and other, net.

Non-Marketable Equity Securities

We have accounted for non-marketable equity security investments at historical cost because we do not have significant influence over the underlying investees. These investments are subject to a periodic impairment review. To the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

extent any impairment is considered other-than-temporary, the investment is written down to its fair value and the loss is recorded as interest income and other, net.

Accounts Receivable

Accounts receivable are recorded at the invoiced amount and are non-interest bearing. We maintain an allowance for doubtful accounts to reserve for potentially uncollectible receivables. We review the accounts receivable by amounts due by customers which are past due to identify specific customers with known disputes or collectibility issues. In determining the amount of the reserve, we make judgments about the creditworthiness of significant customers based on ongoing credit evaluations. We also maintain a sales allowance to reserve for potential credits issued to customers. The amount of the reserve is determined based on historical credits issued.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally two to five years. Buildings are depreciated over periods up to 25 years. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful lives of the assets. Construction in process is primarily related to the construction or development of property and equipment. Depreciation for equipment commences once it is placed in service and depreciation for buildings and leasehold improvements commences once they are ready for their intended use.

Software Development Costs

We account for software development costs, including costs to develop software products or the software component of products to be marketed to external users, as well as software programs to be used solely to meet our internal needs in accordance with SFAS No. 86, *Accounting for Costs of Computer Software to be Sold, Leased, or Otherwise Marketed* and Statement of Position No. 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use*. We have determined that technological feasibility for our products to be marketed to external users was reached shortly before the release of those products. As a result, the development costs incurred after the establishment of technological feasibility and before the release of those products were not material, and accordingly, were expensed as incurred. In addition, costs incurred during the application development stage for software programs to be used solely to meet our internal needs were not material.

Long-Lived Assets Including Goodwill and Other Acquired Intangible Assets

We review property and equipment and intangible assets, excluding goodwill, for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of these assets is measured by comparison of carrying amounts to the future undiscounted cash flows the assets are expected to generate. If property and equipment and intangible assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair market value. We have made no material adjustments to our long-lived assets in any of the years presented. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, we test our goodwill for impairment at least annually or more frequently if events or changes in circumstances indicate that this asset may be impaired. Our tests are based on our single operating segment and reporting unit structure. We found no material impairment in any of the years presented.

SFAS No. 142 also requires that intangible assets with definite lives be amortized over their estimated useful lives and reviewed for impairment whenever events or changes in circumstances indicate an asset's carrying value may not be recoverable in accordance with SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. We are currently amortizing our acquired intangible assets with definite lives over periods ranging primarily from one to seven years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Income Taxes

We recognize income taxes under the liability method. Deferred income taxes are recognized for differences between the financial reporting and tax bases of assets and liabilities at enacted statutory tax rates in effect for the years in which differences are expected to reverse. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date.

Foreign Currency

Generally, the functional currency of our international subsidiaries is the local currency. The financial statements of these subsidiaries are translated to U.S. dollars using month-end rates of exchange for assets and liabilities, and average rates of exchange for revenues, costs and expenses. Translation gains and losses are recorded in accumulated other comprehensive income as a component of stockholders' equity. We recorded \$18.0 million of net translation losses, and \$38.6 million and \$61.0 million of net translation gains in 2005, 2006 and 2007, respectively. Net gains and losses resulting from foreign exchange transactions are recorded as interest income and other, net. These gains and losses are net of those realized on forward foreign exchange contracts. We recorded \$6.3 million and \$5.3 million of net gains, and \$16.2 million of net losses in 2005, 2006 and 2007 from assets and liabilities denominated in a currency other than the local currency.

Derivative Financial Instruments

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

In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, we recognize derivative instruments as either assets or liabilities on the balance sheet at fair value. These forward exchange contracts are not accounted for as hedges and, therefore, changes in the fair value of these instruments are recorded as interest income and other, net. Neither the cost nor the fair value of these forward foreign exchange contracts was material at December 31, 2007. The notional principal of forward foreign exchange contracts to purchase U.S. dollars with foreign currencies was \$735.7 million and \$1,498.6 million at December 31, 2006 and December 31, 2007. The notional principal of forward foreign exchange contracts to purchase euros with British pounds, Japanese yen, Australian dollars and Swedish Krona was €296.5 million (or approximately \$433.4 million) at December 31, 2007. There were no other forward foreign exchange contracts outstanding at December 31, 2006 or December 31, 2007.

Legal Costs

Legal costs are expensed as incurred.

Advertising and Promotional Expenses

We expense advertising and promotional costs in the period in which they are incurred. For the years ended December 31, 2005, 2006 and 2007 promotional and advertising expenses totaled approximately \$104.3 million, \$188.4 million and \$236.7 million.

Effect of Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, on December 14, 2007, the FASB issued proposed FSP FAS 157-b which would delay the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This proposed FSP partially defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. Effective for 2008, we will adopt SFAS 157 except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in proposed FSP FAS 157-b. The partial adoption of SFAS 157 will not have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—including an Amendment of FASB Statement No. 115* (“SFAS 159”), which allows an entity to choose to measure certain financial instruments and liabilities at fair value. Subsequent measurements for the financial instruments and liabilities an entity elects to fair value will be recognized in earnings. SFAS 159 also establishes additional disclosure requirements. SFAS 159 is effective for us beginning January 1, 2008. We are currently evaluating the potential impact of the adoption of SFAS 159 on our consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (“SFAS 141R”). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. This statement is effective for us beginning January 1, 2009. We are currently evaluating the potential impact of the adoption of SFAS 141R on our consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51* (“SFAS 160”). SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent’s ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective for us beginning January 1, 2009. We are currently evaluating the potential impact of the adoption of SFAS 160 on our consolidated financial position, results of operations or cash flows.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 2. Net Income Per Share of Class A and Class B Common Stock

We compute net income per share of Class A and Class B common stock in accordance with SFAS No. 128, *Earnings per Share* (“SFAS 128”) using the two class method. Under the provisions of SFAS 128, basic net income per share is computed using the weighted average number of common shares outstanding during the period except that it does not include unvested common shares subject to repurchase or cancellation. Diluted net income per share is computed using the weighted average number of common shares and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options, warrants, restricted shares, restricted stock units and unvested common shares subject to repurchase or cancellation. The dilutive effect of outstanding stock options, restricted shares, restricted stock units and warrants is reflected in diluted earnings per share by application of the treasury stock method. The computation of the diluted net income per share of Class A common stock assumes the conversion of Class B common stock, while the diluted net income per share of Class B common stock does not assume the conversion of those shares.

The rights, including the liquidation and dividend rights, of the holders of our Class A and Class B common stock are identical, except with respect to voting. Further, there are a number of safeguards built into our Certificate of Incorporation, as well as Delaware law, which preclude our board of directors from declaring or paying unequal per share dividends on our Class A and Class B common stock. Specifically, Delaware law provides that amendments to our Certificate of Incorporation which would have the affect of adversely altering the rights, powers or preferences of a given class of stock (in this case the right of our Class A common stock to receive an equal dividend to any declared on our Class B common stock) must be approved by the class of stock adversely affected by the proposed amendment. In addition, our Certificate of Incorporation provides that before any such amendment may be put to a stockholder vote, it must be approved by the unanimous consent of our Board of Directors. As a result, and in accordance with EITF 03-6, *Participating Securities and the Two-Class Method under FASB Statement No. 128*, the undistributed earnings for each year are allocated based on the contractual participation rights of the Class A and Class B common shares as if the earnings for the year had been distributed. As the liquidation and dividend rights are identical, the undistributed earnings are allocated on a proportionate basis. Further, as we assume the conversion of Class B common stock in the computation of the diluted net income per share of Class A common stock, the undistributed earnings are equal to net income for that computation.

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

	Year Ended December 31,					
	2005		2006		2007	
	Class A	Class B	Class A	Class B	Class A	Class B
Basic net income per share:						
Numerator:						
Allocation of undistributed earnings	\$ 858,184	\$607,213	\$2,197,851	\$879,595	\$3,131,292	\$1,072,428
Denominator:						
Weighted average common shares outstanding	165,513	117,109	216,589	86,681	232,131	79,421
Less: Weighted average unvested common shares subject to repurchase or cancellation	(3,970)	(2,808)	(1,333)	(534)	(616)	(130)
Number of shares used in per share computations	161,543	114,301	215,256	86,147	231,515	79,291
Basic net income per share	\$ 5.31	\$ 5.31	\$ 10.21	\$ 10.21	\$ 13.53	\$ 13.53
Diluted net income per share:						
Numerator:						
Allocation of undistributed earnings for basic computation	\$ 858,184	\$607,213	\$2,197,851	\$879,595	\$3,131,292	\$1,072,428
Reallocation of undistributed earnings as a result of conversion of Class B to Class A shares	607,213	—	879,595	—	1,072,428	—
Reallocation of undistributed earnings to Class B shares	—	(1,823)	—	(3,134)	—	(7,732)
Allocation of undistributed earnings	\$1,465,397	\$605,390	\$3,077,446	\$876,461	\$4,203,720	\$1,064,696
Denominator:						
Number of shares used in basic computation	161,543	114,301	215,256	86,147	231,515	79,291
Weighted average effect of dilutive securities Add:						
Conversion of Class B to Class A common shares outstanding	114,301	—	86,147	—	79,291	—
Unvested common shares subject to repurchase or cancellation	6,778	2,808	1,867	534	746	130
Employee stock options	8,899	3,471	5,916	1,479	3,690	667
Restricted shares and restricted stock units	353	—	362	—	968	—
Number of shares used in per share computations	291,874	120,580	309,548	88,160	316,210	80,088
Diluted net income per share	\$ 5.02	\$ 5.02	\$ 9.94	\$ 9.94	\$ 13.29	\$ 13.29

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.