

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 3. Cash, Cash Equivalents and Marketable Securities

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

	As of December 31,	
	2006	2007
Cash and cash equivalents:		
Cash	\$ 1,579,702	\$ 2,869,528
Cash equivalents:		
U.S. government agencies	323,900	110,272
Time deposits	—	500,000
Municipal securities	216,529	232,278
Money market mutual funds	1,424,540	2,369,515
Total cash and cash equivalents	<u>3,544,671</u>	<u>6,081,593</u>
Marketable securities:		
U.S. government notes	2,697,880	475,781
U.S. government agencies	2,839,430	2,120,972
Municipal securities	1,622,570	4,991,564
Time deposits	500,000	500,000
Auction rate preferred securities	39,363	48,703
Total marketable securities	<u>7,699,243</u>	<u>8,137,020</u>
Total cash, cash equivalents and marketable securities	<u>\$11,243,914</u>	<u>\$14,218,613</u>

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

	As of December 31, 2006			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government notes	\$2,704,753	\$1,201	\$ (8,074)	\$2,697,880
U.S. government agencies	2,838,759	4,081	(3,410)	2,839,430
Municipal securities	1,627,428	197	(5,055)	1,622,570
Time deposits	500,000	—	—	500,000
Auction rate preferred securities	39,363	—	—	39,363
Total marketable securities	<u>\$7,710,303</u>	<u>\$5,479</u>	<u>\$(16,539)</u>	<u>\$7,699,243</u>
	As of December 31, 2007			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government notes	\$ 472,040	\$ 3,745	\$ (4)	\$ 475,781
U.S. government agencies	2,102,710	18,306	(44)	2,120,972
Municipal securities	4,975,587	16,308	(331)	4,991,564
Time deposits	500,000	—	—	500,000
Auction rate preferred securities	48,703	—	—	48,703
Total marketable securities	<u>\$8,099,040</u>	<u>\$38,359</u>	<u>\$(379)</u>	<u>\$8,137,020</u>

Bank time deposits were held by institutions outside the U.S. in 2006 and 2007.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Gross unrealized gains and losses on cash equivalents were not material at December 31, 2006 and 2007. We did not experience any significant realized gains or losses on our investments in 2005. We recognized a net realized gain of \$40.2 million on the sale of marketable securities in 2006 primarily as a result of realized gain of \$54.9 million on the sale of one of our equity investments. In 2007, we recognized gross realized gains and losses of \$81.7 million and \$30.5 million on our marketable securities. There were no other-than-temporary impairments to our marketable securities in 2005, 2006 and 2007. Realized gains and losses are included in interest income and other, net in our accompanying Consolidated Statements of Income.

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

	As of December 31, 2007
Due within 1 year	\$1,964,325
Due within 1 year through 5 years	3,359,472
Due within 5 years through 10 years	310,332
Due after 10 years	<u>2,454,188</u>
Total marketable debt securities	<u><u>\$8,088,317</u></u>

In accordance with EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, the following table shows gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2006 and 2007, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in thousands):

Security Description	As of December 31, 2006					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government notes	\$ 893,264	\$(3,339)	\$1,138,237	\$(4,735)	\$2,031,501	\$ (8,074)
U.S. government agencies	1,620,106	(2,603)	193,178	(807)	1,813,284	(3,410)
Municipal securities	676,089	(1,473)	248,953	(3,582)	925,042	(5,055)
Total	<u>\$3,189,459</u>	<u>\$(7,415)</u>	<u>\$1,580,368</u>	<u>\$(9,124)</u>	<u>\$4,769,827</u>	<u>\$(16,539)</u>

Security Description	As of December 31, 2007					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government notes	\$ 30,525	\$ (4)	\$ —	\$ —	\$ 30,525	\$ (4)
U.S. government agencies	98,682	(41)	19,993	(3)	118,675	(44)
Municipal securities	270,708	(227)	54,832	(104)	325,540	(331)
Total	<u>\$ 399,915</u>	<u>\$ (272)</u>	<u>\$ 74,825</u>	<u>\$ (107)</u>	<u>\$ 474,740</u>	<u>\$ (379)</u>

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 4. Non-Marketable Equity Securities

In April 2006, we completed our \$1.0 billion cash purchase of a five percent equity interest in a wholly-owned subsidiary of Time Warner, Inc. that owns all of the outstanding interests of America Online (“AOL”). Our investment in this non-marketable equity security is accounted for at historical cost (see Note 1). In March 2006, we entered into certain commercial arrangements with AOL. We believe that the terms of the investment and commercial agreements are at fair value, and as a result, they are accounted for in accordance with their contractual terms.

Further, we are obligated over a five year term to make up to \$100 million of co-marketing payments (but not to exceed \$20 million per year plus any amounts not spent in prior years) and issue up to \$300 million of AdWords credits (but not to exceed \$60 million per year plus any credits not redeemed in prior years). Co-marketing costs are expensed as incurred, and AdWords credits are accounted for as a reduction to revenues in the periods they are redeemed. At December 31, 2007, our remaining co-marketing and AdWords credits commitments were \$79 million and \$193 million, respectively.

We did not experience any material impairment charges on our non-marketable equity securities in the years presented.

Note 5. Interest Income and Other, Net

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

	Year Ended December 31,		
	2005	2006	2007
Interest income	\$121,038	\$412,063	\$559,205
Interest expense	(776)	(257)	(1,203)
Other	4,137	49,238	31,578
Interest income and other, net	<u>\$124,399</u>	<u>\$461,044</u>	<u>\$589,580</u>

Note 6. Property and Equipment

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

	As of December 31,	
	2006	2007
Information technology assets	\$1,778,028	\$2,734,916
Construction in process	850,164	1,364,651
Land and buildings	352,112	951,334
Leasehold improvements	273,262	416,884
Furniture and fixtures	36,028	52,127
Total	3,289,594	5,519,912
Less accumulated depreciation and amortization	894,355	1,480,651
Property and equipment, net	<u>\$2,395,239</u>	<u>\$4,039,261</u>

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 7. Acquisitions

In September 2007, we completed the acquisition of Postini, Inc., a provider of information security and compliance solutions. This transaction was accounted for as a business combination. The purchase price was \$545.7 million, paid in cash, including direct transaction costs of \$1.0 million. The following table summarizes the allocation of the purchase price of Postini (in thousands):

Goodwill	\$ 446,471
Customer relationships	104,310
Patents and developed technology	35,510
Tradenames and other	5,630
Net assets acquired	8,240
Deferred tax liabilities	(54,507)
Total	<u>\$ 545,654</u>

Net assets acquired include involuntary termination benefits of \$16.6 million that we expect to pay certain Postini employees. In addition, we are obligated to make cash payments of up to \$44.8 million through 2011, contingent upon each employee's continued employment with us. These contingent payments will be expensed, when and if earned.

Goodwill is not deductible for tax purposes.

Customer relationships, patents and developed technology, and tradenames and other intangible assets have weighted-average useful lives of 6.8 years, 4.0 years and 2.6 years from the date of acquisition. These assets are not deductible for tax purposes.

Supplemental information on an unaudited pro forma basis, as if the Postini acquisition had been consummated at the beginning of each of the periods presented, is as follows (in millions, except per share amounts):

	Year Ended December 31,		
	2005	2006	2007
		(unaudited)	
Revenues	\$6,180.5	\$10,663.1	\$16,651.1
Net income	\$1,423.0	\$ 3,032.0	\$ 4,165.5
Net income per share of Class A and Class B common stock—diluted	\$ 4.88	\$ 9.79	\$ 13.17

The unaudited pro forma supplemental information is based on estimates and assumptions, which we believe are reasonable; it is not necessarily indicative of our consolidated financial position or results of income in future periods or the results that actually would have been realized had we been a combined company during the periods presented. The unaudited pro forma supplemental information includes incremental intangible asset amortization and other charges as a result of the acquisition, net of the related tax effects.

During the year ended December 31, 2007, we also completed seventeen other acquisitions. Three of these transactions were accounted for as asset purchases in accordance with EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*, as the acquired companies were considered to be development stage enterprises. The remaining fourteen transactions were accounted for as business combinations. The total initial purchase price for these transactions was \$281.6 million and was paid or will be paid in cash. In addition, we are obligated to make additional cash payments of up to \$72.4 million if certain performance targets are met through 2010. Since these contingent payments are based on the achievement of performance targets, actual payments may be substantially lower. A portion of these contingent payments will be accounted for as goodwill, and the remaining amounts will be expensed, when and if earned.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In addition, during the year ended December 31, 2007, we capitalized intangible assets of \$5.2 million, paid in cash, related to patent purchases.

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

Goodwill	\$201,067
Patents and developed technology	81,275
Customer relationships	13,230
Tradenames and other	6,200
Net assets acquired	6,181
Deferred tax liabilities	(25,947)
Purchased in-process research and development	4,790
Total	<u><u>\$286,796</u></u>

Goodwill expected to be deductible for tax purposes is \$5.1 million.

Patents and developed technology, customer relationships, and tradenames and other intangible assets have a weighted-average useful life of 3.7 years, 3.8 years and 3.3 years from the date of acquisition. The amount expected to be deductible for tax purposes is \$7.6 million.

Purchased in-process research and development was expensed at the time of the acquisitions because technological feasibility had not been established and no future alternative uses existed. This amount was included in research and development expenses on the accompanying Consolidated Statements of Income.

In connection with certain acquisitions in the current and prior years, we are obligated to make additional cash payments if certain criteria are met. As of December 31, 2007, our remaining contingent obligations related to these acquisitions was approximately \$800 million. Since these contingent payments are based on the achievement of performance targets, actual payments may be substantially lower.

Agreement and Plan of Merger with DoubleClick

In April 2007, we entered into an Agreement and Plan of Merger with DoubleClick to acquire all of the outstanding interests of DoubleClick, a privately held company, for \$3.1 billion in cash, plus the cash and cash equivalents of DoubleClick, plus the aggregate exercise price for outstanding options and stock appreciation rights for DoubleClick common stock, as well as certain other adjustments, minus certain unpaid third party expenses incurred by DoubleClick in connection with this transaction and minus all indebtedness for borrowed money of DoubleClick.

In addition, unvested options and stock appreciation rights for DoubleClick common stock will be converted into options to purchase our common stock with economic terms similar to outstanding vested equity interests.

Although the transaction has been cleared by the Federal Trade Commission in the U.S., the completion of this transaction is subject to various customary conditions, including receiving antitrust clearance from the European Commission. We and DoubleClick have each agreed to take all actions necessary to obtain the requisite antitrust and other regulatory approvals.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 8. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the years ended December 31, 2006 and 2007 are as follows (in thousands):

Balance as of December 31, 2005	\$ 194,900
Goodwill acquired	1,350,219
Balance as of December 31, 2006	1,545,119
Goodwill acquired	647,538
Goodwill adjustment	106,711
Balance as of December 31, 2007	<u>\$2,299,368</u>

The goodwill adjustment of \$106.7 million was primarily a result of contingent payments earned upon the achievement of certain performance targets and adjustments for goodwill amounts in connection with the YouTube acquisition.

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

	<u>As of December 31, 2006</u>		
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Value</u>
Patents and developed technology	\$241,185	\$ 95,927	\$145,258
Customer relationships	60,636	16,359	44,277
Tradenames and other	183,721	26,415	157,306
Total	<u>\$485,542</u>	<u>\$138,701</u>	<u>\$346,841</u>

	<u>As of December 31, 2007</u>		
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Value</u>
Patents and developed technology	\$364,937	\$179,102	\$185,835
Customer relationships	171,876	37,738	134,138
Tradenames and other	196,392	69,769	126,623
Total	<u>\$733,205</u>	<u>\$286,609</u>	<u>\$446,596</u>

In addition, during the year ended December 31, 2007, we capitalized intangible assets of \$11.6 million, paid in cash, related to milestone payments for acquisitions completed prior to 2007.

Patents and developed technology, customer relationships, and tradenames and other have weighted-average useful lives from the date of purchase of 3.4 years, 5.6 years and 4.2 years. Amortization expense of acquisition-related intangible assets for the years ended December 31, 2005, 2006 and 2007 were \$37.0 million, \$74.2 million and \$158.2 million. Expected amortization expense for acquisition-related intangible assets on our December 31, 2007 Consolidated Balance Sheet for each of the next five years is as follows (in thousands):

2008	\$163,565
2009	111,327
2010	80,244
2011	48,770
2012	15,556
Thereafter	27,134
	<u>\$446,596</u>

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 9. Commitments and Contingencies

Operating Leases

We have entered into various non-cancelable operating lease agreements for certain of our offices, land and data centers throughout the world with original lease periods expiring between 2008 and 2051. We are committed to pay a portion of the related operating expenses under certain of these lease agreements. These operating expenses are not included in the table below. Certain of these arrangements have free or escalating rent payment provisions. We recognize rent expense under such arrangements on a straight line basis.

At December 31, 2007, future minimum payments under non-cancelable operating leases, along with sublease income amounts, are as follows over each of the next five years and thereafter (in thousands):

	Operating Leases	Sub-lease Income	Net Operating Leases
2008	\$ 169,574	\$18,001	\$ 151,573
2009	185,157	16,649	168,508
2010	174,194	14,038	160,156
2011	159,764	12,810	146,954
2012	149,767	7,991	141,776
Thereafter	<u>1,446,525</u>	<u>11,853</u>	<u>1,434,672</u>
Total minimum payments required	<u>\$2,284,981</u>	<u>\$81,342</u>	<u>\$2,203,639</u>

Rent expense under operating leases was \$41.2 million, \$80.7 million and \$127.9 million in 2005, 2006, and 2007. Sub-lease income was not material in any year presented.

The above minimum payments at December 31, 2007 under non-cancelable operating lease commitments and the above rent expense amounts do not include amounts related to certain non-cancelable service contracts for our data centers. The non-cancelable commitments under these service contracts at December 31, 2007 are included below under purchase obligations.

Guaranteed Minimum Revenue Share Payments

In connection with our AdSense revenue share agreements, we are periodically required to make non-cancelable guaranteed minimum revenue share payments to a small number of our Google Network members over the term of the respective contracts. These guaranteed payments can vary based on our Google Network members achieving defined performance terms, such as number of advertisements displayed or search queries. In some cases, certain guaranteed amounts will be adjusted downward if our Google Network members do not meet their performance terms and, in some cases, these amounts will be adjusted upward if they exceed their performance terms. In all of these AdSense agreements, if a Google Network member were unable to perform under the contract, such as being unable to provide search queries, as defined under the terms of that agreement, then we would not be obligated to make any non-cancelable guaranteed minimum revenue share payments to that member. At December 31, 2007, our aggregate outstanding non-cancelable guaranteed minimum revenue share commitments totaled \$1,746.4 million through 2012 compared to \$1,165.6 million at December 31, 2006.

Purchase Obligations

We had \$734.0 million of other non-cancelable contractual obligations and \$1,375.8 million of open purchase orders for which we had not received the related services or goods at December 31, 2007. We have the right to cancel these open

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

purchase orders prior to the date of delivery. The majority of these purchase obligations are related to data center operations and facility build-outs. These non-cancelable contractual obligations and open purchase orders amounts do not include payments we may be obligated to make based upon vendors achieving certain milestones.

Letters of Credit

At December 31, 2007 and associated with several leased facilities, we had unused letters of credit for \$20.4 million. At December 31, 2007, we were in compliance with our financial covenants under the letters of credit.

Indemnifications

In the normal course of business to facilitate transactions of our services and products, we indemnify certain parties, including advertisers, Google Network members and lessors, with respect to certain matters. We have agreed to hold certain parties harmless against losses arising from a breach of representations or covenants, or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. In addition, we have entered into indemnification agreements with our officers and directors, and our bylaws contain similar indemnification obligations to our agents.

It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by us under these agreements have not had a material impact on our operating results, financial position, or cash flows.

Legal Matters

Companies have filed trademark infringement and related claims against us over the display of ads in response to user queries that include trademark terms. The outcomes of these lawsuits have differed from jurisdiction to jurisdiction. Courts in France have held us liable for allowing advertisers to select certain trademarked terms as keywords. We are appealing those decisions. We were also subject to two lawsuits in Germany on similar matters where the courts held that we are not liable for the actions of our advertisers prior to notification of trademark rights. We are litigating or have recently litigated similar issues in other cases in the U.S., France, Germany, Israel, Italy, Austria and Australia.

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

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

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

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Income Taxes

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

Upon adoption of FIN 48 on January 1, 2007, we decreased current taxes payable by \$219.4 million and increased long-term taxes payable by the same amount as FIN 48 specifies that tax positions for which the timing of the ultimate resolution is uncertain should be recognized as long-term liabilities. We also recognized additional long-term taxes payable of \$181.0 million in the year ended December 31, 2007. At this time, we are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

Note 10. Google Foundation

The Google Foundation (the "Foundation"), a private foundation, was formed in the third quarter of 2004. The Foundation's mission is to fund and support philanthropic programs focused on poverty and the environment. In the fourth quarter of 2005, we funded the Foundation with non-recourse, non-refundable cash donation of \$90.0 million.

The Board of Directors of the Foundation currently consists of four members, two of whom are directors and executive officers of Google and one of whom is a vice president of Google. The fourth member is the executive director of the Foundation.

Since the Foundation's inception, we have provided at no charge certain resources to the Foundation such as office space.

Note 11. Stockholders' Equity

Convertible Preferred Stock

Our Board of Directors has authorized 100,000,000 shares of convertible preferred stock, \$0.001 par value, issuable in series. At December 31, 2007 and 2006, there were no shares issued or outstanding.

Class A and Class B Common Stock

Our Board of Directors has authorized two classes of common stock, Class A and Class B. At December 31, 2007, there were 6,000,000,000 and 3,000,000,000 shares authorized and there were 236,432,822 and 76,844,348 shares legally outstanding of Class A and Class B common stock. The rights of the holders of Class A and Class B common stock are identical, except with respect to voting. Each share of Class A common stock is entitled to one vote per share. Each share of Class B common stock is entitled to 10 votes per share. Shares of Class B common stock may be converted at any time at the option of the stockholder and automatically convert upon sale or transfer to Class A common stock. We refer to Class A and Class B common stock as common stock throughout the notes to these financial statements, unless otherwise noted.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

At December 31, 2006 and December 31, 2007 there were 20,410,337 and 14,553,423 shares of common stock reserved for future issuance.

Stock Plans

We maintain the 1998 Stock Plan, the 2000 Stock Plan, the 2003 Stock Plan, the 2003 Stock Plan (No. 2), the 2003 Stock Plan (No. 3), the 2004 Stock Plan and plans assumed through acquisitions, all of which are collectively referred to as the "Stock Plans." Under our Stock Plans, incentive and nonqualified stock options or rights to purchase common stock may be granted to eligible participants. Options are generally granted for a term of 10 years. Options granted under the Stock Plans generally vest 25% after the first year of service and ratably each month over the remaining 36 month period contingent upon employment with us on the date of vest. Options granted under Stock Plans other than the 2004 Stock Plan may be exercised prior to vesting.

Under the stock plans, we have also issued RSUs and restricted shares. An RSU award is an agreement to issue shares of our stock at the time of vest. RSUs issued to new employees vest over four years with a yearly cliff contingent upon employment with us on the dates of vest. These RSUs vest from zero to 37.5 percent of the grant amount at the end of each of the four years from date of hire based on the employee's performance. RSUs under the Founders' Award programs are issued to individuals on teams that have made extraordinary contributions to Google. These awards vest quarterly over four years contingent upon employment with us on the dates of vest.

We estimated the fair value of each option award on the date of grant using the BSM option pricing model. Our assumptions about stock-price volatility have been based exclusively on the implied volatilities of publicly traded options to buy our stock with contractual terms closest to the expected life of options granted to our employees applying the guidance provided by Staff Accounting Bulletin No. 107, *Share-Based Payment*. Through the third quarter of 2007, our assumptions about the expected term have been based on that of companies that have option vesting and contractual terms, expected stock volatility and employee demographics and physical locations that are similar to ours because we had limited relevant historical information to support the expected sale and exercise behavior of our employees who had been granted options recently. Commencing in the fourth quarter of 2007, we began to estimate the expected term based upon the historical behavior of our employees. The risk-free interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

The fair value of share-based payment awards was estimated using the BSM option pricing model with following assumptions and weighted average fair values:

	Year Ended December 31,		
	2005	2006	2007
Risk-free interest rate	3.86%	4.70%	4.37%
Expected volatility	36%	34%	34%
Expected life (in years)	3.1	3.6	5.1
Dividend yield	—	—	—
Weighted-average estimated fair value of options granted during the year	\$78.58	\$158.59	\$213.56

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes the activity for our options for the twelve months ended December 31, 2007:

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions)(1)
Balance at December 31, 2006	13,424,872	\$205.58		
Options granted	3,408,101	\$562.95		
Exercised/vested	(3,572,930)	\$ 51.86		
Canceled/forfeited	(367,157)	\$264.11		
Balance at December 31, 2007	12,892,886	\$333.62	7.5	\$4,483.92
Vested and exercisable as of December 31, 2007	4,405,716	\$211.10	7.0	\$2,116.43
Vested and exercisable as of December 31, 2007 and expected to vest thereafter(2)	12,001,757	\$330.70	7.5	\$4,330.04

- (1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the closing stock price of \$691.48 of our common stock on December 31, 2007.
- (2) Options expected to vest reflect an estimated forfeiture rate.

The following table summarizes additional information regarding outstanding and exercisable options at December 31, 2007:

Range of Exercise Prices	Options Outstanding				Options Exercisable		Options Exercisable and Vested		
	Total Number of Shares	Unvested Options Granted and Exercised Subsequent to March 21, 2002	Number of Shares	Weighted-Average Remaining Life (Years)	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	
\$0.30-\$85.00	2,639,312	360,679	2,278,633	5.7	\$ 18.07	2,230,265	\$ 17.84	1,349,487	\$ 15.37
\$117.84-\$198.41	1,678,669	—	1,678,669	5.9	\$176.42	933,713	\$175.27	933,367	\$175.27
\$205.96-\$298.91	1,391,439	—	1,391,439	6.5	\$274.52	700,523	\$274.30	700,177	\$274.30
\$300.97-\$399.00	1,789,518	—	1,789,518	7.1	\$329.55	813,173	\$326.68	811,819	\$326.64
\$401.78-\$499.07	1,469,211	—	1,469,211	8.5	\$449.90	284,533	\$431.24	283,671	\$431.24
\$500.00-\$594.05	3,721,507	—	3,721,507	9.4	\$556.92	328,015	\$508.02	326,881	\$508.02
\$625.39-\$699.35	150,577	—	150,577	9.9	\$663.13	78	\$664.55	78	\$664.55
\$707.00-\$732.94	52,653	—	52,653	9.9	\$718.16	36	\$707.00	36	\$707.00
\$0.30-\$732.94	12,892,886	360,679	12,532,207	7.5	\$333.56	5,290,336	\$179.70	4,405,516	\$211.10

Options outstanding at December 31, 2006 and 2007 in the above tables include 1,296,155 and 360,679 of options granted and exercised subsequent to March 21, 2002 that are unvested at December 31, 2006 and 2007, in accordance with EITF 00-23. However, the computations of the weighted-average exercise prices, weighted average remaining contractual term and aggregate intrinsic value for all stock options outstanding and those exercisable do not consider these unvested shares. Further, the above tables include 924,399 warrants held by financial institutions that were options purchased from employees under our TSO program.

The total grant date fair value of stock options vested (including the related incremental fair value resulting from the adoption of our TSO program—see discussion below) during 2005, 2006 and 2007 was \$287.5 million, \$392.9 million

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

and \$635.1 million. The aggregate intrinsic value of all options exercised during 2005, 2006 and 2007 was \$1,785.3 million, \$1,904.0 million and \$1,279.0 million—these amounts do not include the aggregate sales price of options sold under the TSO program (see below).

In April 2007, we launched our TSO program. Under the TSO program, certain employees are able to sell vested options granted after our initial public offering under our 2004 Stock Plan to selected financial institutions in an online auction. All employees may participate in the program other than our executive management group and those who reside in countries where, due to local legal or tax implications, it would not be beneficial to employees or the TSO program would be impractical. At the time of sale, the vested option is automatically amended to create a warrant that is exercisable by the financial institution within two years from the date of issuance. All eligible outstanding options were modified in the second quarter of 2007 to allow them to be sold under the TSO program and, as a result, we incurred a modification charge of \$95 million during 2007 related to vested options and 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. The modification charge is equal to the difference between the values of those modified stock options on the date of modification and their values immediately prior to modification in accordance with SFAS 123R. Further, to the extent the forfeiture rate is different from what we have anticipated, the modification charge related to the unvested awards will be different from our expectations. 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.

During 2007, the number of shares underlying TSOs sold to selected financial institutions under the TSO program was 924,399 at a total value of \$305.0 million, or an average \$329.92 per share, and an average premium of \$31.43 per share. The premium is calculated as the difference between (a) the sale price of the TSO and (b) the intrinsic value of the TSO, which we define as the excess, if any, of the price of our Class A common stock at the time of the sale over the exercise price of the TSO. At December 31, 2007, the number of shares underlying TSOs held by financial institutions was 924,399 and the number of options eligible for participation under the TSO program was approximately 8.7 million.

As of December 31, 2007, there was \$1,165.1 million of unrecognized compensation cost related to outstanding employee stock options, net of forecasted forfeitures. This amount is expected to be recognized over a weighted average period of 2.97 years. To the extent the forfeiture rate is different than what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

The following table summarizes the activity for our unvested restricted stock units and restricted shares for the twelve months ended December 31, 2007:

	Number of Shares	Weighted-Average Grant-Date Fair Value
Unvested at December 31, 2006	1,771,037	\$369.54
Granted	1,870,558	\$618.61
Vested	(570,863)	\$362.81
Forfeited	(80,510)	\$396.85
Unvested at December 31, 2007	<u>2,990,222</u>	<u>\$526.92</u>
Expected to vest at December 31, 2007	<u>2,795,858</u>	<u>\$526.92</u>

As of December 31, 2007, there was \$1,332.6 million of unrecognized compensation cost related to employee unvested restricted stock units and restricted shares, net of forecasted forfeitures. This amount is expected to be recognized over a weighted average period of 3.42 years. To the extent the actual forfeiture rate is different than what we have anticipated; stock-based compensation related to these awards will be different from our expectations.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

At December 31, 2007, there were 2,063 unvested restricted stock units held by a non-employee with a 30 month remaining vesting period.

Warrants to Purchase Class A Common Stock

We issued warrants to purchase 15,904 shares of Class A common stock in connection with our YouTube acquisition. The warrants have an exercise price of \$23.28 and a nine month remaining vesting period at December 31, 2007.

Note 12. 401(k) Plan

We have a 401(k) Savings Plan (the “401(k) Plan”) that qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Under the 401(k) Plan, participating employees may elect to contribute up to 60% of their eligible compensation, subject to certain limitations. We match employee contributions up to \$7,750 per year. Employee and our contributions are fully vested when contributed. We contributed approximately \$8.4 million, \$14.3 million and \$51.1 million during 2005, 2006 and 2007, respectively.

Note 13. Income Taxes

Income before income taxes included income from foreign operations of approximately \$590.8 million, \$1,318.4 million and \$2,466.9 million for 2005, 2006 and 2007.

The provision for income taxes consisted of the following (in thousands):

	Year Ended December 31,		
	2005	2006	2007
Current:			
Federal	\$506,322	\$ 812,280	\$1,288,310
State	141,101	191,266	294,935
Foreign	7,694	28,516	51,227
Total	655,117	1,032,062	1,634,472
Deferred:			
Federal	14,273	(80,073)	(135,047)
State	6,890	(18,395)	(29,165)
Total	21,163	(98,468)	(164,212)
Provision for income taxes	<u>\$676,280</u>	<u>\$ 933,594</u>	<u>\$1,470,260</u>

The reconciliation of federal statutory income tax rate to our effective income tax rate is as follows (in thousands):

	Year ended December 31,		
	2005	2006	2007
Expected provision at federal statutory rate (35%)	\$ 749,588	\$1,403,864	\$1,985,893
State taxes, net of federal benefit	96,194	112,366	172,750
Stock-based compensation expense	25,058	26,878	123,869
Disqualifying dispositions of incentive stock options	(46,092)	(6,128)	—
Foreign rate differential	(134,185)	(505,729)	(705,400)
Federal research credit	(12,287)	(77,859)	(81,469)
Tax exempt interest	(20,177)	(31,583)	(50,662)
Other permanent differences	18,181	11,785	25,279
Provision for income taxes	<u>\$ 676,280</u>	<u>\$ 933,594</u>	<u>\$1,470,260</u>

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

We provide U.S. income taxes on the earnings of foreign subsidiaries unless the subsidiaries' earnings are considered permanently reinvested outside the U.S. To the extent that the foreign earnings previously treated as permanently reinvested are repatriated, the related U.S. tax liability may be reduced by any foreign income taxes paid on these earnings. As of December 31, 2007, the cumulative amount of earnings upon which U.S. income taxes have not been provided is approximately \$3,900.6 million. Determination of the amount of unrecognized deferred tax liability related to these earnings is not practicable.

Deferred Tax Assets

Deferred income taxes reflect the net effects of temporary differences between the carrying amounts of assets and liabilities for financing reporting purposes and the amounts used for income tax purposes. Significant components of our deferred tax assets and liabilities are as follows (in thousands):

	As of December 31,	
	2006	2007
Deferred tax assets:		
Stock-based compensation	\$ 40,772	\$ 118,297
State taxes	—	86,256
Depreciation	26,009	53,900
Vacation accruals	11,256	18,868
Deferred Rent	9,565	17,498
Accruals and reserves not currently deductible	6,867	9,824
Unrealized losses on investments and other	1,996	—
Other	4,242	14,674
Total deferred tax assets	100,707	319,317
Deferred tax liabilities:		
Identified intangibles	(107,781)	(127,700)
Undistributed earnings of foreign subsidiaries	—	(55,329)
Unrealized gains on investments and other	—	(30,187)
Other	(3,634)	(4,344)
Total deferred tax liabilities	(111,415)	(217,560)
Net deferred tax assets (liabilities)	\$ (10,708)	\$ 101,757

As of December 31, 2007, our federal net operating loss carryforwards for income tax purposes were approximately \$22.1 million. If not utilized, the federal net operating loss carryforwards will begin to expire in 2024. The net operating loss carryforwards are subject to various limitations under Section 382 of the Internal Revenue Code.

Uncertain Tax Positions

Effective January 1, 2007, we adopted the provisions of FIN 48. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109 and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. Upon adoption of FIN 48, our policy to include interest and penalties related to gross unrecognized tax benefits within our provision for income taxes did not change. The adjustment to retained earnings upon adoption to FIN 48 on January 1, 2007 was \$2.3 million.

Google Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes the activity related to our gross unrecognized tax benefits from January 1, 2007 to December 31, 2007 (in thousands):

Balance as of January 1, 2007	\$243,588
Increases related to prior year tax positions	29,854
Decreases related to prior year tax positions	(18,997)
Increases related to current year tax positions	132,742
Decreases related to settlements with taxing authorities	—
Decreases related to lapsing of statute of limitations	—
Balance as of December 31, 2007	<u>\$387,187</u>

Our total unrecognized tax benefits that, if recognized, would affect our effective tax rate were \$195.7 million and \$283.5 million as of January 1, 2007 and December 31, 2007

As of December 31, 2007, we had accrued \$14 million for payment of interest. Interest included in our provision for income taxes was not material in all the periods presented. We have not accrued any penalties related to our uncertain tax positions as we believe that it is more likely than not that there will not be any assessment of penalties.

We and our subsidiaries are routinely examined by various taxing authorities. Although we file U.S. federal, U.S. state, and foreign tax returns, our two major tax jurisdictions are the U.S. and Ireland. During the fourth quarter ended December 31, 2007, IRS completed its examination of our 2003 and 2004 tax years. We have filed an appeal with the IRS for certain issues related to this audit, but we believe we have adequately provided for these items and any adverse results would have an immaterial impact on our unrecognized tax benefit balance within the next twelve months. The IRS will commence its examination of our 2005 and 2006 tax years in early 2008. We do not expect the examination to be completed within the next twelve months, therefore we do not anticipate any significant impact to our unrecognized tax benefit balance in 2008, related to 2005 and 2006 tax years.

Our 2003 through 2007 tax years remain subject to examination by the IRS for U.S. federal tax purposes, and our 2002 through 2007 tax years remain subject to examination by the appropriate governmental agencies for Irish tax purposes. There are various other on-going audits in various other jurisdictions that are not material to our financial statements.

Note 14. Information about Geographic Areas

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