

SOHU COM INC  
Form 10-Q  
August 08, 2013  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2013**

**OR**

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

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

**COMMISSION FILE NUMBER 0-30961**

**Sohu.com Inc.**

**(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)**

Edgar Filing: SOHU COM INC - Form 10-Q

**Delaware**  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)  
**Level 18, SOHU.com Media Plaza**  
**Block 3, No. 2 Kexueyuan South Road, Haidian District**  
**Beijing 100190**  
**People's Republic of China**  
**(011) 8610-6272-6666**

**98-0204667**  
(I.R.S. EMPLOYER  
IDENTIFICATION NUMBER)

(Address, including zip code, of registrant's principal executive offices and registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Class	Outstanding at June 30, 2013
Common stock, \$.001 par value	38,278,691

**Table of Contents****SOHU.COM INC.****Table of Contents**

	<b>PAGE</b>
<b>PART I</b>	
<b><u>FINANCIAL INFORMATION</u></b>	
Item 1	
<u>Condensed Consolidated Financial Statements (unaudited)</u>	3
<u>Condensed Consolidated Balance Sheets as of June 30, 2013 and December 31, 2012</u>	3
<u>Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2013 and 2012</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2013 and 2012</u>	5
<u>Condensed Consolidated Statements of Changes in Equity for the Six Months Ended June 30, 2013 and 2012</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	8
Item 2	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	40
Item 3	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	65
Item 4	
<u>Controls and Procedures</u>	66
<b>PART II</b>	
<b><u>OTHER INFORMATION</u></b>	
Item 1	
<u>Legal Proceedings</u>	66
Item 1A	
<u>Risk Factors</u>	66
Item 2	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	66
Item 3	
<u>Defaults Upon Senior Securities</u>	66
Item 4	
<u>Mine Safety Disclosures</u>	66
Item 5	
<u>Other Information</u>	66
Item 6	
<u>Exhibits</u>	66
<u>Signatures</u>	67
<u>Exhibit Index</u>	68

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SOHU.COM INC.****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)****(In thousands, except par value)**

	June 30, 2013	As of December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 770,542	\$ 833,535
Restricted time deposits	169,324	116,140
Short-term investments	97,123	54,901
Investments in debt securities	80,923	79,548
Accounts receivable, net	138,612	98,398
Prepaid and other current assets	87,677	55,761
<b>Total current assets</b>	<b>1,344,201</b>	<b>1,238,283</b>
Fixed assets, net	496,359	178,951
Goodwill	161,409	159,215
Intangible assets, net	67,181	70,054
Restricted time deposits	173,190	130,699
Prepaid non-current assets	10,296	291,643
Other assets	16,852	13,792
<b>Total assets</b>	<b>\$ 2,269,488</b>	<b>\$ 2,082,637</b>
<b>LIABILITIES</b>		
Current liabilities:		
Accounts payable (including accounts payable of consolidated variable interest entities ( VIEs ) without recourse to the Company of \$9,449 and \$6,958, respectively, as of June 30, 2013 and December 31, 2012)	\$ 81,585	\$ 67,934
Accrued liabilities (including accrued liabilities of consolidated VIEs without recourse to the Company of \$43,320 and \$53,034, respectively, as of June 30, 2013 and December 31, 2012)	145,801	117,029
Receipts in advance and deferred revenue (including receipts in advance and deferred revenue of consolidated VIEs without recourse to the Company of \$47,505 and \$54,150, respectively, as of June 30, 2013 and December 31, 2012)	90,488	89,687
Accrued salary and benefits (including accrued salary and benefits of consolidated VIEs without recourse to the Company of \$3,736 and \$4,940, respectively, as of June 30, 2013 and December 31, 2012)	72,583	61,722
Taxes payable (including taxes payable of consolidated VIEs without recourse to the Company of \$13,351 and \$14,191, respectively, as of June 30, 2013 and December 31, 2012)	35,882	33,897
Deferred tax liabilities (including deferred tax liabilities of consolidated VIEs without recourse to the Company of \$23 and \$83, respectively, as of June 30, 2013 and December 31, 2012)	15,395	11,878
Short-term bank loans (including short-term bank loans of consolidated VIEs without recourse to the Company of nil as of both June 30 and December 31, 2012)	164,000	113,000
Other short-term liabilities (including other short-term liabilities of consolidated VIEs without recourse to the Company of \$16,102 and \$33,074, respectively, as of June 30, 2013 and December 31, 2012)	49,070	63,352
Contingent consideration (including contingent consideration of consolidated VIEs without recourse to the Company of nil as of both June 30, 2013 and December 31, 2012)	0	76
<b>Total current liabilities</b>	<b>654,804</b>	<b>558,575</b>

## Edgar Filing: SOHU COM INC - Form 10-Q

Long-term accounts payable (including long-term accounts payable of consolidated VIEs without recourse to the Company of \$1,215 and nil, respectively, as of June 30, 2013 and December 31, 2012)	7,423	12,684
Long-term bank loans (including long-term bank loans of the consolidated VIEs without recourse to the Company of nil as of both June 30, 2013 and December 31, 2012)	158,963	126,353
Deferred tax liabilities (including deferred tax liabilities of the consolidated VIEs without recourse to the Company of \$3,450 and \$3,846, respectively, as of June 30, 2013 and December 31, 2012)	7,571	7,998
<b>Total long-term liabilities</b>	<b>173,957</b>	<b>147,035</b>
<b>Total liabilities</b>	<b>828,761</b>	<b>705,610</b>
Commitments and contingencies		
<b>MEZZANINE EQUITY</b>	<b>0</b>	<b>61,810</b>
<b>SHAREHOLDERS EQUITY</b>		
Sohu.com Inc. shareholders' equity:		
Common stock: \$0.001 par value per share (75,400 shares authorized; 38,279 shares and 38,089 shares, respectively, issued and outstanding as of June 30, 2013 and December 31, 2012)	44	44
Additional paid-in capital	375,322	364,092
Treasury stock (5,889 shares)	(143,858)	(143,858)
Accumulated other comprehensive income	99,413	79,542
Retained earnings	830,460	784,403
<b>Total Sohu.com Inc. shareholders' equity</b>	<b>1,161,381</b>	<b>1,084,223</b>
Noncontrolling interest	279,346	230,994
<b>Total shareholders' equity</b>	<b>1,440,727</b>	<b>1,315,217</b>
<b>Total liabilities, mezzanine equity and shareholders' equity</b>	<b>\$ 2,269,488</b>	<b>\$ 2,082,637</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****SOHU.COM INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)****(In thousands, except per share data)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
<b>Revenues:</b>				
<b>Online advertising:</b>				
Brand advertising	\$ 100,191	\$ 69,312	\$ 180,428	\$ 130,280
Search and others	46,171	28,763	82,223	50,400
Subtotal of online advertising revenues	146,362	98,075	262,651	180,680
Online games	168,295	135,956	335,716	261,924
Mobile	15,313	15,598	29,086	28,949
Others	8,934	6,098	19,047	10,778
<b>Total revenues</b>	<b>338,904</b>	<b>255,727</b>	<b>646,500</b>	<b>482,331</b>
<b>Cost of revenues:</b>				
<b>Online advertising:</b>				
Brand advertising	51,556	50,963	96,434	87,855
Search and others	24,498	16,192	45,290	29,320
Subtotal of cost of online advertising revenues	76,054	67,155	141,724	117,175
Online games	22,981	17,891	45,630	33,722
Mobile	8,963	10,208	18,235	19,061
Others	5,647	4,590	11,585	9,408
<b>Total cost of revenues</b>	<b>113,645</b>	<b>99,844</b>	<b>217,174</b>	<b>179,366</b>
<b>Gross profit</b>	<b>225,259</b>	<b>155,883</b>	<b>429,326</b>	<b>302,965</b>
<b>Operating expenses:</b>				
Product development	63,361	43,340	115,180	81,933
Sales and marketing	71,678	48,999	130,401	87,653
General and administrative	25,772	17,508	48,361	35,302
Impairment of intangible assets via acquisition of Businesses	0	2,906	0	2,906
<b>Total operating expenses</b>	<b>160,811</b>	<b>112,753</b>	<b>293,942</b>	<b>207,794</b>
<b>Operating profit</b>	<b>64,448</b>	<b>43,130</b>	<b>135,384</b>	<b>95,171</b>
Other income	1,532	1,818	4,063	3,431
Interest income	5,498	7,223	12,199	13,718
Exchange difference	(1,984)	45	(3,969)	(598)
<b>Income before income tax expense</b>	<b>69,494</b>	<b>52,216</b>	<b>147,677</b>	<b>111,722</b>
<b>Income tax expense</b>	<b>16,251</b>	<b>18,467</b>	<b>36,269</b>	<b>37,154</b>

Edgar Filing: SOHU COM INC - Form 10-Q

Net income	53,243	33,749	111,408	74,568
Less: Net income attributable to the mezzanine-classified noncontrolling interest shareholders	7,112	1,095	17,780	2,206
Net income attributable to the noncontrolling interest shareholders	24,505	19,872	47,571	36,472
Net income attributable to Sohu.com Inc.	\$ 21,626	\$ 12,782	\$ 46,057	\$ 35,890
Net income	53,243	33,749	111,408	74,568
Other comprehensive income /(loss): Foreign currency translation adjustment, net of tax	20,429	(5,455)	25,232	(3,668)
Comprehensive income	73,672	28,294	136,640	70,900
Less: Comprehensive income attributable to the mezzanine-classified noncontrolling interest shareholders	7,112	1,095	17,780	2,206
Comprehensive income attributable to noncontrolling interest shareholders	28,800	19,045	52,932	35,970
Comprehensive income attributable to Sohu.com Inc.	37,760	8,154	65,928	32,724
Basic net income per share attributable to Sohu.com Inc.	\$ 0.57	\$ 0.34	\$ 1.21	\$ 0.95
Shares used in computing basic net income per share attributable to Sohu.com Inc.	38,259	38,002	38,214	38,043
Diluted net income per share attributable to Sohu.com Inc.	\$ 0.56	\$ 0.28	\$ 1.16	\$ 0.81
Shares used in computing diluted net income per share attributable to Sohu.com Inc.	38,492	38,347	38,461	38,416

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****SOHU.COM INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)****(In thousands)**

	<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 111,408	\$ 74,568
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation	23,833	17,959
Share-based compensation expense	2,325	6,359
Amortization of intangible assets and purchased video content in prepaid expense	32,309	34,395
Impairment of purchased video content	0	15,275
Impairment of other intangible assets	1,444	3,564
Provision /(Reversal) for allowance for doubtful accounts	(386)	3,260
Excess tax benefits from share-based payment arrangements	0	(2,519)
Investment income from investments in debt securities	(2,748)	(2,727)
Others	(1,507)	(243)
<b>Changes in assets and liabilities, net of acquisition:</b>		
Accounts receivable	(38,516)	(26,853)
Prepaid and other assets	(24,002)	(135)
Deferred tax	6,133	5,590
Accounts payable	5,534	12,899
Taxes payable	1,744	(9,313)
Accrued liabilities	21,410	771
Receipts in advance and deferred revenue	1,141	(6,655)
Other short-term liabilities	11,604	9,612
<b>Net cash provided by operating activities</b>	<b>151,726</b>	<b>135,807</b>
<b>Cash flows from investing activities:</b>		
Purchase of noncontrolling interest in 7Road	(76,010)	0
Purchase of fixed assets	(48,655)	(32,631)
Purchase of intangible and other assets	(38,942)	(27,462)
Cash paid related to restricted time deposits	(90,963)	(240)
Purchase of short-term investments, net	(40,682)	(4,299)
Other acquisitions, net of cash acquired	0	(683)
Other cash proceeds /(payments) related to investing activities	281	(2,877)
<b>Net cash used in investing activities</b>	<b>(294,971)</b>	<b>(68,192)</b>
<b>Cash flows from financing activities:</b>		
Issuance of common stock	784	139
Sohu's purchase of Sogou Series A Preferred Shares from Alibaba	0	(25,800)
Repurchase of common stock	0	(12,566)
Proceeds of loans from offshore banks	81,000	0
Payment of contingent consideration	(19,736)	0
Excess tax benefits from share-based payment arrangements	0	2,519
Exercise of share-based awards in subsidiary	1,324	1,360
Proceeds received from early exercise of share-based awards in subsidiary	5,278	0
Other cash payments related to financing activities	(188)	(251)
<b>Net cash provided by /(used in) financing activities</b>	<b>68,462</b>	<b>(34,599)</b>
Effect of exchange rate changes on cash and cash equivalents	11,790	(1,025)



Edgar Filing: SOHU COM INC - Form 10-Q

Net (decrease) /increase in cash and cash equivalents	(62,993)	31,991
Cash and cash equivalents at beginning of period	833,535	732,607
Cash and cash equivalents at end of period	\$ 770,542	\$ 764,598
Supplemental cash flow disclosures:		
Barter transactions	374	229
Supplemental schedule of non-cash investing activity:		
Consideration payable for the purchase of noncontrolling interest in 7Road	2,000	0
Changes in government grant in prepaid and other current assets	1,066	794

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

## SOHU.COM INC.

## CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (unaudited)

Six Months Ended June 30, 2013

(In thousands)

	Sohu.com Inc. Shareholders Equity						
	Total	Common Stock	Additional Paid-in Capital	Treasury Stock	Accumulated		Noncontrolling Interest
Comprehensive Income					Retained Earnings		
Beginning balance	\$ 1,315,217	\$ 44	\$ 364,092	\$ (143,858)	\$ 79,542	\$ 784,403	\$ 230,994
Issuance of common stock	784	0	784	0	0	0	0
Share-based compensation expense	2,286	0	1,581	0	0	0	705
Purchase of noncontrolling interest in 7Road	2,257	0	1,517	0	0	0	740
Settlement of share-based awards in subsidiary	1,323	0	7,348	0	0	0	(6,025)
Net income attributable to Sohu.com Inc. and noncontrolling interest shareholders	93,628	0	0	0	0	46,057	47,571
Foreign currency translation adjustment, net of tax	25,232	0	0	0	19,871	0	5,361
Ending balance	\$ 1,440,727	\$ 44	\$ 375,322	\$ (143,858)	\$ 99,413	\$ 830,460	\$ 279,346

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****SOHU.COM INC.****CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (unaudited)****Six Months Ended June 30, 2012**

(In thousands)

	Sohu.com Inc. Shareholders Equity						
	Total	Common Stock	Additional Paid-in Capital	Treasury Stock	Accumulated		
Comprehensive Income					Retained Earnings	Noncontrolling Interest	
Beginning balance	\$ 1,219,071	\$ 44	\$ 366,210	\$ (131,292)	\$ 76,219	\$ 697,244	\$ 210,646
Issuance of common stock	139	0	139	0	0	0	0
Repurchase of common stock	(12,566)			(12,566)			
Share-based compensation expense	6,359	0	3,180	0	0	0	3,179
Settlement of share-based awards in subsidiary	1,361	0	(7,364)	0	0	0	8,725
Sohu's purchase of Sogou Series A Preferred Shares from Alibaba	(25,800)	0	(14,219)	0	0	0	(11,581)
Changes in mezzanine equity of Changyou	6,836	0	6,836	0	0	0	0
Transaction cost for Sohu's sale of the 17173 Business to Changyou	118	0	118	0	0	0	0
Deemed contribution from noncontrolling shareholders (related to Sohu's sale of the 17173 Business to Changyou)	0	0	171	0	0	0	(171)
Excess tax benefits from share-based awards	2,519	0	2,519	0	0	0	0
Net income attributable to Sohu.com Inc. and noncontrolling interest shareholders	72,362	0	0	0	0	35,890	36,472
Foreign currency translation adjustment, net of tax	(3,668)	0	0	0	(3,166)	0	(502)
Ending balance	\$ 1,266,731	\$ 44	\$ 357,590	\$ (143,858)	\$ 73,053	\$ 733,134	\$ 246,768

The accompanying notes are an integral part of these condensed consolidated financial statements.

---

**Table of Contents**

**SOHU.COM INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. The Company and Basis of Presentation**

*Nature of Operations*

Sohu.com Inc. (Sohu or the Company), a Delaware corporation organized in 1996, is a leading online media, search, gaming, community and mobile service group providing comprehensive online products and services in the People's Republic of China (the PRC or China). The Company, together with its wholly-owned and majority-owned subsidiaries and variable interest entities (collectively the Sohu Group or the Group), mainly offers online advertising services, online game services and mobile services.

Online advertising and online games are the core businesses of the Sohu Group.

*Online Advertising*

The online advertising business consists of the brand advertising business as well as the search and others business. The brand advertising business offers advertisements on the Sohu Group's Web properties to companies seeking to increase their brand awareness online. The search and others business, provided by Sohu's search subsidiary Sogou Inc. (Sogou), primarily offers customers pay-for-click services, as well as online marketing services on the Sogou Web Directory.

*Online Games*

The online game business is conducted by Sohu's majority-owned subsidiary Changyou.com Limited (Changyou).

The online game business consists of the development, operation and licensing of massively multiplayer online games (MMOGs), which are interactive online games that may be played simultaneously by hundreds of thousands of game players, Web games, which are played over the Internet using a Web browser, and mobile games. Changyou currently operates several MMOGs in China, including the in-house developed Tian Long Ba Bu (TLBB), and developed, and primarily jointly operates with third-party joint operators, DDTank and Wartune (also known as Shen Qu), which are two popular Web games in China.

*Basis of Consolidation*

The consolidated financial statements include the accounts of Sohu and its wholly-owned and majority-owned subsidiaries and consolidated VIEs. All intercompany transactions are eliminated.

*VIE Consolidation*

The Sohu Group adopted the guidance of accounting for VIEs, which requires VIEs to be consolidated by the primary beneficiary of the entity. For consolidated VIEs, management made evaluations of the relationships between the Sohu Group and the VIEs and the economic benefit flow of contractual arrangements with the VIEs. In connection with such evaluation, management also took into account the fact that, as a result of such contractual arrangements, the Group controls the shareholders' voting interests in these VIEs. As a result of such evaluation, management concluded that the Sohu Group is the primary beneficiary of its consolidated VIEs. The Sohu Group has one VIE that is not consolidated since the Group is not the primary beneficiary.

*Noncontrolling Interest Recognition*

Noncontrolling interests are recognized to reflect the portion of the equity of majority-owned subsidiaries and VIEs which is not attributable, directly or indirectly, to the controlling shareholders.

***Basis of Presentation***

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These financial statements should be read in conjunction with the consolidated financial statements and related footnotes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

**Table of Contents**

The accompanying unaudited condensed consolidated interim financial statements reflect all normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results for the interim periods presented. Results for the six months ended June 30, 2013 are not necessarily indicative of the results expected for the full fiscal year or for any future period. Certain comparative figures have been reclassified to conform to the current presentation.

*Reclassification of revenues and costs related to Changyou Internet value-added services ( IVAS )*

Commencing January 1, 2013, in order to provide a better foundation for understanding Changyou's performance, both revenues and costs generated from the operation of third-party Web games by the 17173 business were reclassified from the online game business to IVAS in the others business. To conform to current period presentations, the relevant amounts for prior periods have been reclassified accordingly. Such reclassifications amounted to \$1.2 million and \$2.7 million, respectively, for revenues and \$0.4 million and \$1.0 million for costs, respectively, for the three and six months ended June 30, 2012.

**2. Segment Information**

The Sohu Group's segments are business units that offer different services and are reviewed separately by the chief operating decision maker ( CODM ), or the decision making group, in deciding how to allocate resources and in assessing performance. The Group's CODM is Sohu.com Inc.'s Chief Executive Officer. There are five segments in the Group, consisting of brand advertising, Sogou (which mainly consists of the search and others business), Changyou (which mainly consists of the online game business), mobile and others.

Some items, such as share-based compensation expense, operating expenses, other income and expense, and income tax expense, are not reviewed by the CODM. These items are disclosed in the segment information for reconciliation purposes only.

The following tables present summary information by segment (in thousands):

	Three Months Ended June 30, 2013							
	Brand Advertising, Mobile and Others				Sogou	Changyou	Eliminations	Consolidated
	Brand Advertising	Mobile	Others	Brand Advertising, Mobile and Others				
Revenues (1)	\$ 92,298	\$ 15,313	\$ 2,524	\$ 110,135	\$ 49,874	\$ 182,371	\$ (3,476)	\$ 338,904
Segment cost of revenues	(48,372)	(8,963)	(837)	(58,172)	(24,495)	(30,976)	96	(113,547)
Segment gross profit /(loss)	\$ 43,926	\$ 6,350	\$ 1,687	51,963	25,379	151,395	(3,380)	225,357
SBC (2) in cost of revenues				(60)	(3)	(35)	0	(98)
Gross profit				51,903	25,376	151,360	(3,380)	225,259
Operating expenses:								
Product development				(22,115)	(14,650)	(26,188)	0	(62,953)
Sales and marketing				(46,960)	(9,447)	(18,450)	3,380	(71,477)
General and administrative				(9,699)	(2,428)	(13,113)	0	(25,240)
SBC (2) in operating expenses				(535)	(261)	(347)	2	(1,141)
Total operating expenses				(79,309)	(26,786)	(58,098)	3,382	(160,811)
Operating profit /(loss)				(27,406)	(1,410)	93,262	2	64,448
Other income				937	82	513	0	1,532
Interest income				1,171	272	4,055	0	5,498
Exchange difference				(458)	143	(1,669)	0	(1,984)

## Edgar Filing: SOHU COM INC - Form 10-Q

Income /(loss) before income tax expense	(25,756)	(913)	96,161	2	69,494
Income tax expense	(2,366)	(6)	(13,879)	0	(16,251)
Net income	\$ (28,122)	\$ (919)	\$ 82,282	\$ 2	\$ 53,243

Note (1): The elimination for segment revenues mainly consists of marketing services provided by the brand advertising segment (banner advertisements etc.) to the Changyou segment.

Note (2): SBC stands for share-based compensation expense.

**Table of Contents**

<b>Three Months Ended June 30, 2012</b>								
<b>Brand Advertising, Mobile and Others</b>								
	<b>Brand Advertising</b>	<b>Mobile</b>	<b>Others</b>	<b>Brand Advertising, Mobile and Others</b>	<b>Sogou</b>	<b>Changyou</b>	<b>Eliminations</b>	<b>Consolidated</b>
Revenues (1)	\$ 63,647	\$ 15,598	\$ 2,252	\$ 81,497	\$ 30,397	\$ 147,341	\$ (3,508)	\$ 255,727
Segment cost of revenues	(49,861)	(10,208)	(280)	(60,349)	(16,154)	(23,493)	76	(99,920)
Segment gross profit /(loss)	\$ 13,786	\$ 5,390	\$ 1,972	21,148	14,243	123,848	(3,432)	155,807
SBC (2) in cost of revenues				191	(38)	(77)	0	76
Gross profit				21,339	14,205	123,771	(3,432)	155,883
Operating expenses:								
Product development				(16,231)	(9,347)	(16,231)	0	(41,809)
Sales and marketing				(31,342)	(6,160)	(14,432)	3,432	(48,502)
General and administrative				(7,283)	(1,262)	(7,486)	0	(16,031)
Impairment of intangible assets via acquisitions of businesses				0	0	(2,906)	0	(2,906)
SBC (2) in operating expenses				(1,311)	(1,295)	(899)	0	(3,505)
Total operating expenses				(56,167)	(18,064)	(41,954)	3,432	(112,753)
Operating profit /(loss)				(34,828)	(3,859)	81,817	0	43,130
Other income				1,261	3	554	0	1,818
Interest income				3,089	99	4,035	0	7,223
Exchange difference				178	41	(174)	0	45
Income /(loss) before income tax expense				(30,300)	(3,716)	86,232	0	52,216
Income tax expense				(2,393)	0	(16,074)	0	(18,467)
Net income				\$ (32,693)	\$ (3,716)	\$ 70,158	\$ 0	\$ 33,749

Note (1): The elimination for segment revenues mainly consists of marketing services provided by the brand advertising segment (banner advertisements etc.) to the Changyou segment.

Note (2): SBC stands for share-based compensation expense.



**Table of Contents**

	Six Months Ended June 30, 2013								
	Brand Advertising, Mobile and Others								
	Brand Advertising,		Mobile		Sogou		Changyou	Eliminations	Consolidated
	Brand Advertising	Mobile	Others	Brand Advertising, Mobile and Others	Sogou	Changyou	Eliminations	Consolidated	
Revenues (1)	\$ 167,966	\$ 29,086	\$ 7,154	\$ 204,206	\$ 89,204	\$ 359,956	\$ (6,866)	\$ 646,500	
Segment cost of revenues	(90,593)	(18,234)	(2,109)	(110,936)	(45,285)	(61,005)	220	(217,006)	
Segment gross profit /(loss)	\$ 77,373	\$ 10,852	\$ 5,045	93,270	43,919	298,951	(6,646)	429,494	
SBC (2) in cost of revenues				(138)	(5)	(25)	0	(168)	
Gross profit				93,132	43,914	298,926	(6,646)	429,326	
Operating expenses:									
Product development				(40,808)	(27,431)	(46,183)	0	(114,422)	
Sales and marketing				(87,833)	(17,374)	(31,467)	6,646	(130,028)	
General and administrative				(17,450)	(4,068)	(25,817)	0	(47,335)	
SBC (2) in operating expenses				(1,159)	(411)	(589)	2	(2,157)	
Total operating expenses				(147,250)	(49,284)	(104,056)	6,648	(293,942)	
Operating profit /(loss)				(54,118)	(5,370)	194,870	2	135,384	
Other income				2,161	86	1,816	0	4,063	
Interest income				3,638	606	7,955	0	12,199	
Exchange difference				(582)	147	(3,534)	0	(3,969)	
Income /(loss) before income tax expense				(48,901)	(4,531)	201,107	2	147,677	
Income tax expense				(5,751)	(6)	(30,512)	0	(36,269)	
Net income				\$ (54,652)	\$ (4,537)	\$ 170,595	\$ 2	\$ 111,408	

Note (1): The elimination for segment revenues mainly consists of marketing services provided by the brand advertising segment (banner advertisements etc.) to the Changyou segment.

Note (2): SBC stands for share-based compensation expense.

**Table of Contents**

	Six Months Ended June 30, 2012							
	Brand Advertising, Mobile and Others				Sogou	Changyou	Eliminations	Consolidated
	Brand Advertising	Mobile	Others	Brand Advertising, Mobile and Others				
Revenues (1)	\$ 119,900	\$ 28,949	\$ 3,275	\$ 152,124	\$ 53,175	\$ 284,106	\$ (7,074)	\$ 482,331
Segment cost of revenues	(85,295)	(19,061)	(929)	(105,285)	(29,277)	(44,792)	182	(179,172)
Segment gross profit /(loss)	\$ 34,605	\$ 9,888	\$ 2,346	46,839	23,898	239,314	(6,892)	303,159
SBC (2) in cost of revenues				16	(43)	(167)	0	(194)
Gross profit				46,855	23,855	239,147	(6,892)	302,965
Operating expenses:								
Product development				(29,484)	(16,877)	(32,869)	0	(79,230)
Sales and marketing				(58,778)	(10,584)	(24,152)	6,892	(86,622)
General and administrative				(14,701)	(2,711)	(15,459)	0	(32,871)
Impairment of intangible assets via acquisitions of businesses				0	0	(2,906)	0	(2,906)
SBC (2) in operating expenses				(2,508)	(1,588)	(2,069)	0	(6,165)
Total operating expenses				(105,471)	(31,760)	(77,455)	6,892	(207,794)
Operating profit /(loss)				(58,616)	(7,905)	161,692	0	95,171
Other income /(expense)				2,555	(1)	877	0	3,431
Interest income				6,515	188	7,015	0	13,718
Exchange difference				100	27	(725)	0	(598)
Income /(loss) before income tax expense				(49,446)	(7,691)	168,859	0	111,722
Income tax expense				(4,814)	0	(32,340)	0	(37,154)
Net income				\$ (54,260)	\$ (7,691)	\$ 136,519	\$ 0	\$ 74,568

Note (1): The elimination for segment revenues mainly consists of marketing services provided by the brand advertising segment (banner advertisements etc.) to the Changyou segment.

Note (2): SBC stands for share-based compensation expense.

	As of June 30, 2013				
	Brand Advertising, Mobile and Others	Sogou	Changyou	Eliminations	Consolidated
Cash and cash equivalents	\$ 347,093	\$ 50,124	\$ 373,325	\$ 0	\$ 770,542
Accounts receivable, net	100,545	6,079	32,008	(20)	138,612
Fixed assets, net	242,645	44,065	209,649	0	496,359
Total assets (1)	\$ 1,031,392	\$ 104,409	\$ 1,291,915	\$ (158,228)	\$ 2,269,488

Note (1): The elimination for segment assets mainly consists of elimination of long-term investments in subsidiary and associate companies.

	As of December 31, 2012				
	<b>Brand Advertising, Mobile and Others</b>	<b>Sogou</b>	<b>Changyou</b>	<b>Eliminations</b>	<b>Consolidated</b>
Cash and cash equivalents	\$ 433,777	\$ 33,119	\$ 366,639	\$ 0	\$ 833,535
Accounts receivable, net	68,593	6,481	23,364	(40)	98,398
Fixed assets, net	70,262	43,861	64,828	0	178,951
Total assets (1)	\$ 1,038,741	\$ 87,537	\$ 1,114,513	\$ (158,154)	\$ 2,082,637

Note (1): The elimination for segment assets mainly consists of elimination of long-term investments in subsidiary and associate companies.

---

## **Table of Contents**

### **3. Share-Based Compensation Expense**

Sohu, Changyou, Sogou, Fox Video Limited ( Sohu Video ), and 7Road.com Limited ( 7Road ) all have incentive plans for the granting of share-based awards, including common stock /ordinary shares, share options, restricted shares and restricted share units, to their executive officers, management and employees.

#### ***Sohu, Changyou, and Sogou share-based awards***

For Sohu, Changyou and Sogou, share-based compensation expense is recognized as costs and /or expenses in the consolidated statements of comprehensive income based on the fair value of the related share-based awards on their grant dates. Share-based compensation expense is charged to the shareholders' equity or noncontrolling interest section in the consolidated balance sheets.

#### ***Sohu Video share-based awards***

On January 4, 2012, Sohu Video, the holding entity of Sohu's video division, adopted a 2011 Share Incentive Plan (the Video 2011 Share Incentive Plan ) which provides for the issuance of up to 25,000,000 ordinary shares of Sohu Video (amounting to 10% of the outstanding Sohu Video shares on a fully-diluted basis) to management and key employees of the video division and to Sohu management. As of June 30, 2013, grants of options for the purchase of 15,352,200 of ordinary shares of Sohu Video had been made and were effective under the Video 2011 Share Incentive Plan.

For purposes of ASC 718, no grant date may be established until mutual understanding of the option awards' key terms and conditions between Sohu Video and the recipients can be reached, and such mutual understanding cannot be reached until the enterprise value of Sohu Video and hence the fair value of the options is determinable and can be accounted for.

Management concluded that as of June 30, 2013 certain significant factors necessary to determine the fair value of Sohu's video division remained uncertain. On the basis that the broader terms and conditions of the option awards had neither been finalized nor mutually agreed with the recipients, no grant of options occurred for purposes of ASC 718 and hence no share-based compensation expense was recognized for the three months ended June 30, 2013.

#### ***7Road share-based awards***

On July 10, 2012, 7Road adopted a 2012 Share Incentive Plan (the 7Road 2012 Share Incentive Plan ), which initially provided for the issuance to selected directors, officers, employees, consultants and advisors of 7Road of up to 5,100,000 ordinary shares of 7Road (amounting to 5.1% of the then outstanding 7Road shares on a fully-diluted basis). On November 2, 2012, 7Road's Board of Directors and its shareholders approved an increase from 5,100,000 to 15,100,000 ordinary shares (amounting to 13.7% of the then outstanding 7Road shares on a fully-diluted basis) under the 7Road 2012 Share Incentive Plan.

On May 1, 2013, Changyou entered into an agreement to acquire all of the outstanding ordinary shares of 7Road held by the noncontrolling shareholders, representing 28.074% of the outstanding share capital of 7Road. The acquisition closed on June 5, 2013.

On June 28, 2013, 7Road's Board of Directors approved the cancellation of the 7Road 2012 Share Incentive Plan. 7Road concurrently offered to a total of 42 7Road employees holding an aggregate of 2,223,750 restricted share units which had been granted under the 7Road 2012 Share Incentive Plan the right to exchange their restricted share units for, at each employee's election, in each case subject to the employee's continued employment by 7Road, either (i) the right to a cash payment of up to an aggregate of \$2.90 per restricted share unit exchanged, vesting and payable at the rate of 40%, 30% and 30%, respectively, on the first, second and third anniversaries of July 18, 2012, which is the date when the surrendered restricted share units were granted under the 7Road 2012 Share Incentive Plan, or (ii) the right to receive an annual cash bonus, over a seven-year period commencing July 1, 2013, based on adjusted annual cumulative net income of 7Road. All restricted share units held by these 42 holders under the 7Road 2012 Share Incentive Plan as of June 28, 2013 were included in this exchange program.

As the original awards of restricted share units made under the 7Road 2012 Share Incentive Plan included as a vesting condition the completion of an initial public offering (an IPO ), which is not considered probable under it occurs, no share-based compensation expense was recognized for the fair value of the original awards. As of the date of the modification resulting from the exchange program, incremental compensation expense, which is not classified as share-based compensation expense, will be the fair values of the two new compensation schemes included in the exchange program. Under Scheme I, the modification resulted in total incremental compensation expense of \$5.7 million, which will be recognized in the consolidated statements of comprehensive income ratably over the remaining vesting period of the awards for each tranche. For the three months ended June 30, 2013, compensation expense of \$2.5 million was recognized in the consolidated statements of comprehensive income. For scheme II, the incremental compensation expense will vary depending on 7Road's future financial performance.



**Table of Contents****Share-based compensation expense recognition**

Share-based compensation expense was recognized in costs and /or expenses for the three and six months ended June 30, 2013 and 2012, respectively, as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Share-based compensation expense</b>				
Cost of revenues (1)	\$ 98	\$ (76)	\$ 168	\$ 194
Product development expenses	408	1,531	758	2,703
Sales and marketing expenses	201	497	373	1,031
General and administrative expenses	532	1,477	1,026	2,431
	\$ 1,239	\$ 3,429	\$ 2,325	\$ 6,359

Note (1): In the second quarter of 2012, shared-based compensation expense was trued up for forfeited restricted share units which would have become fully vested during the quarter.

There was no capitalized share-based compensation expense for the three and six months ended June 30, 2013 and 2012.

Share-based compensation expense was recognized for share awards of Sohu, Changyou and Sogou as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Share-based compensation expense</b>				
For Sohu share-based awards	\$ 722	\$ 1,478	\$ 1,583	\$ 3,181
For Changyou share-based awards	363	813	572	2,019
For Sogou share-based awards	154	1,138	170	1,159
	\$ 1,239	\$ 3,429	\$ 2,325	\$ 6,359

There was no share-based compensation expense recognized for the share-based awards of Sohu Video and 7Road for any of the periods presented in the above table.

**4. Fair Value Measurements****Fair Value of Financial Instruments**

The Sohu Group's financial instruments include cash equivalents, restricted time deposits, short-term investments, investments in debt securities, accounts receivable, prepaid and other current assets, prepaid non-current assets, accounts payable, accrued liabilities, receipts in advance and deferred revenue, short-term bank loans, other short-term liabilities, long-term accounts payable and long-term bank loans.

U.S. GAAP establishes a three-tier hierarchy to prioritize the inputs used in the valuation methodologies in measuring the fair value of financial instruments. This hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three-tier fair value hierarchy is:

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

Level 2 - include other inputs that are directly or indirectly observable in the market place.

Level 3 - unobservable inputs which are supported by little or no market activity.

**Table of Contents**

The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of June 30, 2013 (in thousands):

Items	As of June 30, 2013	Fair value measurements at reporting date using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 42,867	\$ 0	\$ 42,867	\$ 0
Restricted time deposits	342,514	0	342,514	0
Short-term investments	97,123	0	97,123	0
Investments in debt securities	80,923	0	0	80,923
<b>Total</b>	<b>\$ 563,427</b>	<b>\$ 0</b>	<b>\$ 482,504</b>	<b>\$ 80,923</b>

The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of December 31, 2012 (in thousands):

Items	As of December 31, 2012	Fair value measurements at reporting date using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 291,945	\$ 0	\$ 291,945	\$ 0
Restricted time deposits	246,839	0	246,839	0
Short-term investments	54,901	0	54,901	0
Investments in debt securities	79,548	0	0	79,548
<b>Total</b>	<b>\$ 673,233</b>	<b>\$ 0</b>	<b>\$ 593,685</b>	<b>\$ 79,548</b>

The following table sets forth the reconciliation of the fair value measurements using significant unobservable inputs (level 3) from December 31, 2012 to June 30, 2013 (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Debt Securities	
Beginning balance at December 31, 2012	\$	79,548
Currency translation adjustment		1,375
<b>Ending balance at June 30, 2013</b>	<b>\$</b>	<b>80,923</b>

*Cash equivalents*



## Edgar Filing: SOHU COM INC - Form 10-Q

The Sohu Group's cash equivalents mainly consist of time deposits placed with banks with an original maturity of three months or less. The fair value of time deposits is determined based on the pervasive interest rates in the market, which are also the interest rates as stated in the contracts with the banks. The Group classifies the valuation techniques that use the pervasive interest rates input as Level 2 of fair value measurements. Generally there are no quoted prices in active markets for identical time deposits at the reporting date. In order to determine the fair value, the Group must use observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

### ***Restricted time deposits***

Restricted time deposits are valued based on the prevailing interest rates in the market. The Sohu Group classifies the valuation techniques that use these inputs as Level 2 of fair value measurements.

### ***Changyou loans from offshore banks, secured by time deposits***

In 2012 and 2013, Changyou drew down loans from offshore branches of certain banks for the purposes of expediting the payment of a special one-time cash dividend to its shareholders, providing working capital to support its overseas operations, and funding the acquisition of outstanding noncontrolling interests in 7Road. These bank loans were secured by an equivalent or greater amount of RMB deposits by Changyou in the onshore branches of such banks. The loans from the offshore branches of the lending banks are classified as short-term bank loans or long-term bank loans based on their payment terms.

**Table of Contents**

As of June 30, 2013, the total amount of the bank loans was \$323 million, of which \$221 million carried a floating rate of interest based on the London Inter-Bank Offered Rate ( LIBOR ) and \$102 million carried a fixed rate of interest. For the three and six months ended June 30, 2013, interest income from the restricted time deposits securing the loans was \$3.1 million and \$5.9 million, respectively, and interest expense on the bank loans was \$2.2 million and \$4.1 million, respectively. Of the total amount, \$113 million is repayable in the second half of 2013 and \$210 million is repayable in 2014, respectively.

*Collateral related to Sogou incentive shares trust arrangements*

In February 2013, Sohu deposited \$9 million in cash into restricted time deposit accounts at a bank as collateral for credit facilities provided by the bank to certain Sogou employees. The facilities are intended to fund the employees' early exercise of Sogou share options and related PRC individual income tax. Sohu is not subject to any additional potential payments other than the restricted time deposit amounts, and believes that the fair value of its guarantee liability is immaterial.

*Short-term investments*

In accordance with ASC 825, for investments in financial instruments with a variable interest rate indexed to performance of underlying assets, the Sohu Group elected the fair value method at the date of initial recognition and carried these investments at fair value. Changes in the fair value are reflected in the consolidated statements of comprehensive income as other income/(expense). To estimate fair value, the Group refers to the quoted rate of return provided by banks at the end of each period using the discounted cash flow method. The Group classifies the valuation techniques that use these inputs as Level 2 of fair value measurements.

As of June 30, 2013, the Sohu Group's investments in financial instruments were mainly held by 7Road and totaled approximately \$97.1 million. The investments are issued by commercial banks in China with a variable interest rate indexed to performance of underlying assets. Since these investments' maturity dates are within one year, they are classified as short-term investments. For the three and six months ended June 30, 2013, the Group recorded in the consolidated statements of comprehensive income change in the fair value of short-term investments in the amount of \$0.8 million and \$1.5 million, respectively. For the three and six months ended June 30, 2012, the Group recorded in the consolidated statements of comprehensive income change in the fair value of short-term investments in the amount of \$0.3 million and \$0.6 million, respectively.

*Investments in Debt Securities*

In September 2010, Sohu purchased from a PRC-based company (the Debtor) a convertible debt security in the principal amount of \$74.6 million (or RMB0.5 billion) with interest, payable quarterly in cash, of 3.8% per annum and an initial maturity of twelve months, subject to extension in Sohu's sole discretion for additional sequential six-month periods. The Debtor's obligations on the debt are secured by a pledge from the Debtor's parent company of its entire equity interest in the Debtor. In September 2011, March 2012, September 2012 and March 2013, Sohu extended the maturity of the security for sequential six-month periods, to March 2012, September 2012, March 2013 and September 2013, respectively, with an interest rate of 6.8% per annum. Under the terms of the security, if Sohu continues to extend the maturity of the security to March 31, 2014, it will have the option, exercisable on March 31, 2014, to convert the outstanding principal into fixed percentages of equity interests in two companies which are affiliates of the Debtor.

For the three and six months ended June 30, 2013, interest income generated from this debt security amounted to \$1.39 million and \$2.74 million, respectively. For the three and six months ended June 30, 2012, interest income generated from this debt security amounted to \$1.37 million and \$2.73 million, respectively.

The Sohu Group elected the fair value option to account for its investments in debt securities at their initial recognition. Changes in fair value were recognized in other income/(expense). For the three and six months ended June 30, 2013 and 2012, there was no change in fair value. To estimate fair value, the Group used the income approach, which considers the estimated future return from the investment and the probabilities of getting these returns. The Group classifies the valuation techniques that use these inputs as Level 3 of fair value measurements.

*Other financial instruments*

The followings are other financial instruments not measured at fair value in the consolidated balance sheets, but for which the fair value is estimated for disclosure purposes.

**Table of Contents***Short-term receivables and payables*

Accounts receivable and prepaid and other current assets are financial assets with carrying values that approximate fair value due to their short term nature. Short-term accounts payable, accrued liabilities, receipts in advance and deferred revenue, short-term bank loans and other short-term liabilities are financial liabilities with carrying values that approximate fair value due to their short term nature.

For short-term bank loans, the rates of interest under the agreements with the lending banks were determined based on the prevailing interest rates in the market. The Sohu Group classifies the valuation techniques that use these inputs as Level 2 of fair value measurements. For other short-term receivables and payables, the Group estimated fair values using the discounted cash flow method, which is unobservable in the market. The Group classifies the valuation technique as Level 3 of fair value measurements.

*Prepaid non-current assets and long-term payables*

Prepaid non-current assets are financial assets with carrying values that approximate fair value because the impact of applying a discount rate to the carrying values would be immaterial. Long-term accounts payable and long-term bank loans are financial liabilities with carrying values that approximate fair value due to the change in fair value, after considering the discount rate, being immaterial.

For long-term bank loans, the rates of interest under Changyou's agreements with lending banks were determined based on the prevailing interest rates in the market. The Sohu Group classifies the valuation techniques that use these inputs as Level 2 of fair value measurements. For prepaid non-current assets and long-term accounts payable, the Group estimated fair values using the discounted cash flow method, which is unobservable in the market. The Sohu Group classifies the valuation technique as Level 3 of fair value measurements.

**5. Fixed Assets**

In May 2013, the office building Sohu purchased in 2009 was placed in service. Accordingly, in the same month, the Sohu Group recognized the office building's original cost of \$162 million as fixed assets. The original cost consists primarily of the purchase price and the costs of technological infrastructure and fitting-out work. Also in May 2013, the Group began recognizing depreciation expense based on the building's useful life, which is approximately 41 years, on a straight-line basis.

For Changyou's office building purchased in 2010, as of June 30, 2013, \$144 million had been paid and recognized as construction-in-process under fixed assets in the Sohu Group's consolidated balance sheets, as the construction work of the building had been completed and the technological infrastructure and fitting-out work was still in progress.

**6. Goodwill**

The changes in the carrying value of goodwill by segment are as follows (in thousands):

	<b>Brand Advertising</b>	<b>Mobile</b>	<b>Sogou</b>	<b>Changyou</b>	<b>Total</b>
Balance as of December 31, 2012					
Goodwill	\$ 42,093	\$ 15,942	\$ 2,047	\$ 140,122	\$ 200,204
Accumulated impairment losses	(19,846)	(15,942)	0	(5,201)	(40,989)
	\$ 22,247	\$ 0	\$ 2,047	\$ 134,921	\$ 159,215
Transactions in 2013					
Foreign currency translation adjustment	5	0	35	2,154	2,194
Balance as of June 30, 2013	\$ 22,252	\$ 0	\$ 2,082	\$ 137,075	\$ 161,409

Balance as of June 30, 2013

Edgar Filing: SOHU COM INC - Form 10-Q

Goodwill	\$ 42,098	\$ 15,942	\$ 2,082	\$ 142,276	\$ 202,398
Accumulated impairment losses	(19,846)	(15,942)	0	(5,201)	(40,989)
	\$ 22,252	\$ 0	\$ 2,082	\$ 137,075	\$ 161,409

---

**Table of Contents**

**7. Taxation**

Sohu.com Inc. and Changyou.com (US) Inc. are subject to income taxes in the United States ( U.S. ). The majority of the subsidiaries and VIEs of the Sohu Group are based in mainland China and are subject to income taxes in the PRC. These China-based subsidiaries and VIEs conduct substantially all of the Sohu Group's operations, and generate most of the Sohu Group's income.

The Sohu Group did not have any penalties or significant interest associated with tax positions for the three and six months ended June 30, 2013, nor did the Group have any significant unrecognized uncertain tax positions for the three and six months ended June 30, 2013.

***PRC Corporate Income Tax***

*Related to High and New Technology Enterprises*

The PRC Corporate Income Tax Law (the CIT Law ) applies an income tax rate of 25% to all enterprises but grants preferential tax treatment to High and New Technology Enterprises ( NHTEs ). Under this preferential tax treatment, NHTEs can enjoy a preferential income tax rate of 15% for three years, but need to re-apply after the end of the three-year period. The CIT Law went into effect on January 1, 2008.

Within the Sohu Group, five enterprises, namely Beijing Sohu New Era Information Technology Co., Ltd. ( Sohu Era ), Beijing Sohu New Media Information Technology Co., Ltd. ( Sohu Media ), Beijing Sogou Technology Development Co., Ltd. ( Sogou Technology ), Changyou's China-based subsidiary Beijing AmazGame Age Internet Technology Co., Ltd. ( AmazGame ) and Changyou's China-based VIE Beijing Gamease Age Digital Technology Co., Ltd. ( Gamease ), qualified as NHTEs in 2008 and qualified upon re-application in 2011. Therefore, for these enterprises the income tax rate is 15% for 2013. These enterprises will need to re-apply for NHTE status in 2014.

Two additional enterprises, Beijing Sohu Internet Information Service Co., Ltd. ( Sohu Internet ) and Beijing Sogou Information Service Co., Ltd. ( Sogou Information ), qualified as NHTEs in 2009 and qualified upon re-application in 2012. Therefore, for these enterprises the income tax rate is 15% for 2013 and 2014. These enterprises will need to re-apply for NHTE status in 2015.

*Related to Software Enterprises*

Under the CIT Law, a Software Enterprise can enjoy an income tax exemption for two years beginning with its first profitable year and a 50% tax reduction to a rate of 12.5% for the subsequent three years.

As of June 30, 2013, Shenzhen 7Road Technology Co., Ltd ( Shenzhen 7Road ), Beijing Changyou Gamespace Software Technology Co., Ltd. ( Gamespace ), ICE Information Technology (Shanghai) Co., Ltd. ( ICE Information ), Shanghai ICE Information Technology Co., Ltd. ( Shanghai ICE ) and Shenzhen 7Road Network Technologies Co., Ltd.( 7Road Technology ) were Software Enterprises entitled to the beneficial tax treatment described above.

***PRC Withholding Tax on Dividends***

The CIT Law imposes a 10% withholding income tax for dividends distributed by foreign invested enterprises to their immediate holding companies outside mainland China. A lower withholding tax rate will be applied if there is a tax treaty arrangement between mainland China and the jurisdiction of the foreign holding company. A holding company in Hong Kong, for example, will be subject to a 5% withholding tax rate under the Arrangement Between the PRC and the Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital (the China-HK Tax Arrangement ) if such holding company is considered a non-PRC resident enterprise and holds at least 25% of the equity interests in the PRC foreign invested enterprise distributing the dividends, subject to approval of the PRC local tax authority. However, if the Hong Kong holding company is not considered to be the beneficial owner of such dividends under applicable PRC tax regulations, such dividend may remain subject to a withholding tax rate of 10%.

As of June 30, 2013, Changyou accrued deferred tax liabilities in the amount of \$15.4 million for PRC withholding tax.

## **Table of Contents**

### ***Transition from PRC Business Tax to PRC Value Added Tax***

Effective September 1, 2012, a Pilot Program for transition from the imposition of PRC business tax ( Business Tax ) to the imposition of value added tax ( VAT ) for revenues from certain industries was expanded from Shanghai to eight other cities and provinces in China, including Beijing and Tianjin. On May 24, 2013, it was announced that commencing August 1, 2013 the Pilot Program will be expanded to all regions in PRC. The Sohu Group's brand advertising and search revenues are subject to this program.

Business Tax had been imposed primarily on revenues from the provision of taxable services, assignments of intangible assets and transfers of real estate. Prior to the implementation of the Pilot Program, the Sohu Group's Business Tax rate, which varies depending on the nature of the revenues being taxed, generally ranged from 3% to 5%.

VAT payable on goods sold or taxable labor services provided by a general VAT taxpayer for a taxable period is the net balance of the output VAT for the period after crediting the balance of VAT input. Before the implementation of the Pilot Program, the Sohu Group was mainly subject to a small amount of VAT for revenues of Changyou's subsidiary 7Road that are deemed for PRC tax purposes to be derived from the sale of software. VAT has been imposed on those 7Road revenues at a rate of 17%, with a 14% immediate tax refund, resulting in a net rate of 3%. With the implementation of the Pilot Program, in addition to the revenues currently subject to VAT, the Group's brand advertising and search revenues are in the scope of the Pilot Program and are now subject to VAT at a rate of 6%.

Under ASC 605-45, the presentation of taxes on either a gross basis (included in revenues and costs) or a net basis (excluded from revenues) is an accounting policy decision determined by management. As VAT imposed on brand advertising and search revenues and VAT imposed on 7Road's revenues from the sale of software are considered as substantially different in nature, the Sohu Group determined that it is reasonable to apply the guidance separately for these two types of VAT. The basis for this determination is that VAT payable on brand advertising and search revenues is the difference between the output VAT (at a rate of 6%) and available input VAT amount (at the rate applicable to the supplier), which is a component of the Group's costs for providing the brand advertising and search services. On the other hand, the VAT payable by 7Road is in effect at 3% of the applicable revenues from the sale of software, irrespective of the availability of any input VAT, under preferential VAT treatment provided to 7Road by the local tax bureau. In this regard, the Group believes the VAT payable by 7Road is more akin to a sales tax than typical VAT. As a result, the Group adopted the net presentation method for its brand advertising and search businesses both before and after the implementation of the Pilot Program, and for the revenues of 7Road deemed to be derived from the sale of software, the Group adopted the gross presentation method before and after the implementation of the Pilot Program.

### ***U.S. Corporate Income Tax***

Sohu.com Inc. is a Delaware corporation that is subject to U.S. corporate income tax on its taxable income at a rate of 34% or 35%. Subject to certain limitations, the net operating losses ( NOLs ) of a corporation taxable in the U.S. that are carried forward from prior years may be used to offset the corporation's taxable income. At the end of the 2012 taxable year, Sohu.com Inc. had no further NOLs available for offsetting any U.S. taxable income. Accordingly, to the extent that it has U.S. taxable income in 2013, the Sohu Group will accrue U.S. corporate income tax in its consolidated statements of comprehensive income and make estimated tax payments as and when required by U.S. law.

## **8. Commitments and Contingencies**

### ***Unconditional Obligations***

As of June 30, 2013, the Sohu Group had commitments for bandwidth purchases in the amount of \$45 million, commitments for video content purchases in the amount of \$36 million, commitments for operating leases in the amount of \$26 million and commitments for other content and service purchases in the amount of \$20 million. In addition, for Changyou's office building purchased in 2010, \$144 million of the \$163 million purchase price had been paid as of June 30, 2013 and the remaining \$19 million is expected to be settled by the end of 2013.

### ***Litigation***

The Sohu Group is a party to various litigation matters which it considers routine and incidental to its business. Management does not expect the results of any of these actions to have a material adverse effect on the Group's business, results of operations, financial condition and cash flows.

In the first quarter of 2013, the Sohu Group settled lawsuits with four major record companies (Sony BMG, Warner, Universal and Gold Label) without any payment of damages. In these lawsuits, which were initiated against the Sohu Group in March 2008, these record companies had alleged that the Sohu Group provided music search links and download services that violated copyrights they owned.



---

## **Table of Contents**

### ***PRC Law and Regulations***

The Chinese market in which the Sohu Group operates poses certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability to operate an Internet business and to conduct brand advertising, search and others, online game, mobile and others services in the PRC. Though the PRC has, since 1978, implemented a wide range of market-oriented economic reforms, continued reforms and progress towards a full market-oriented economy are uncertain. In addition, the telecommunication, information, and media industries remain highly regulated. Restrictions are currently in place and are unclear with respect to which segments of these industries foreign-owned entities, like the Sohu Group, may operate. The Chinese government may issue from time to time new laws or new interpretations of existing laws to regulate areas such as telecommunication, information and media. Certain risks related to PRC law that could affect the Sohu Group's VIE structure are discussed in Note 9 - VIEs.

Regulatory risks also encompass interpretation by PRC tax authorities of current tax law, including the applicability of certain preferential tax treatments. The Sohu Group's legal structure and scope of operations in China could be subject to restrictions, which could result in limits on its ability to conduct business in the PRC.

The Sohu Group's sales, purchase and expense transactions are generally denominated in RMB and a significant portion of its assets and liabilities are denominated in RMB. The RMB is not freely convertible into foreign currencies. In China, foreign exchange transactions are required by law to be transacted only by authorized financial institutions. Remittances in currencies other than RMB by its subsidiaries in China may require certain supporting documentation in order to effect the remittance.

## **9. VIEs**

### ***Background***

PRC laws and regulations prohibit or restrict foreign ownership of companies that operate Internet information and content, Internet access, online games, mobile, value added telecommunications and certain other businesses in which the Sohu Group is engaged or could be deemed to be engaged. Consequently, the Sohu Group conducts certain of its operations and businesses in the PRC through its VIEs.

The Sohu Group consolidates in its consolidated financial statements all of the VIEs of which the Group is the primary beneficiary. The Sohu Group has one VIE that is not consolidated in the Group's consolidated financial statements because the Group is not the primary beneficiary.

### ***VIEs Consolidated within the Sohu Group***

The Sohu Group adopted the guidance of accounting for VIEs, which requires VIEs to be consolidated by the primary beneficiary of the entity. Management made evaluations of the relationships between the Sohu Group and its VIEs and the economic benefit flow of contractual arrangements with the VIEs. In connection with such evaluation, management also took into account the fact that, as a result of contractual arrangements with its consolidated VIEs, the Sohu Group controls the shareholders' voting interests in those VIEs. As a result of such evaluation, the management concluded that the Sohu Group is the primary beneficiary of the VIEs which the Group consolidates.

All of the consolidated VIEs are incorporated and operated in the PRC, and are directly or indirectly owned by Dr. Charles Zhang, Sohu's Chairman and Chief Executive Officer, or other executive officers and employees of the Sohu Group identified below. Capital for the consolidated VIEs was funded by the Sohu Group through loans provided to Dr. Charles Zhang and those other executive officers and employees, and was initially recorded as loans to related parties. These loans are eliminated for accounting purposes against the capital of the VIEs upon consolidation.

Under contractual agreements with the Sohu Group, Dr. Charles Zhang and those other executive officers and employees of the Sohu Group who are shareholders of the consolidated VIEs are required to transfer their ownership in these entities to the Group, if permitted by PRC laws and regulations, or, if not so permitted, to designees of the Group at any time as requested by the Group to repay the loans outstanding. All voting rights of the consolidated VIEs are assigned to the Sohu Group, and the Group has the right to designate all directors and senior management personnel of the consolidated VIEs, and also has the obligation to absorb losses of the consolidated VIEs. Dr. Charles Zhang and those other executive officers and employees of the Sohu Group who are shareholders of the consolidated VIEs have pledged their shares in the consolidated VIEs as collateral for the loans. As of June 30, 2013, the aggregate amount of these loans was \$18.6 million.





---

**Table of Contents**

Under its contractual arrangements with the consolidated VIEs, the Sohu Group has the power to direct activities of the VIEs, and can have assets transferred freely out of the VIEs without any restrictions. Therefore, the Group considers that there is no asset of a consolidated VIE that can be used only to settle obligations of the VIEs, except for registered capital and PRC statutory reserves of the VIEs. As of June 30, 2013, the registered capital and PRC statutory reserves of the consolidated VIEs totaled \$31.7 million. As all of the consolidated VIEs are incorporated as limited liability companies under the PRC Company Law, creditors of the consolidated VIEs do not have recourse to the general credit of the Sohu Group for any of the liabilities of the consolidated VIEs. Currently there is no contractual arrangement that could require the Sohu Group to provide additional financial support to the consolidated VIEs. As the Sohu Group is conducting certain business in the PRC mainly through the consolidated VIEs, the Group may provide such support on a discretionary basis in the future, which could expose the Group to a loss.

The following is a summary of the consolidated VIEs within the Sohu Group:

*Basic Information*

Corporate

High Century

Beijing Century High Tech Investment Co., Ltd. ( High Century ) is a holding company which was incorporated in 2001. As of June 30, 2013, the registered capital of High Century was \$4.6 million and Dr. Charles Zhang and Wei Li held 80% and 20% interests, respectively, in this entity.

Sohu Entertainment

Beijing Sohu Entertainment Culture Media Co., Ltd. ( Sohu Entertainment ) was incorporated in 2002. As of June 30, 2013, the registered capital of Sohu Entertainment was \$1.2 million and Xin Wang (Belinda Wang), Sohu's Co-President and Chief Operating Officer, and Ye Deng, a Vice President of Sohu, held 80% and 20% interests, respectively, in this entity.

Sohu Internet

Sohu Internet was incorporated in 2003 and is engaged in the provision of mobile services. As of June 30, 2013, the registered capital of Sohu Internet was \$1.6 million and High Century and Sohu Entertainment held 75% and 25% interests, respectively, in this entity.

For the Online Advertising Business

Brand Advertising Business

Donglin

Beijing Sohu Donglin Advertising Co., Ltd. ( Donglin ) was incorporated in 2010 and is engaged in advertising services. As of June 30, 2013, the registered capital of Donglin was \$1.5 million and High Century and Sohu Internet each held a 50% interest in this entity.

Pilot New Era

Beijing Pilot New Era Advertising Co., Ltd. ( Pilot New Era ) was incorporated in 2010 and is engaged in advertising services. As of June 30, 2013, the registered capital of Pilot New Era was \$0.7 million and High Century and Sohu Internet each held a 50% interest in this entity.

Focus Yiju

Beijing Focus Yiju Network Information Technology Co., Ltd. ( Focus Yiju ) was acquired in 2011 and is engaged in advertising services. As of June 30, 2013, the registered capital of Focus Yiju was \$1.6 million and High Century held a 100% interest in this entity.

Zhi Hui You

Beijing Zhi Hui You Information Technology Co., Ltd. ( Zhi Hui You ) was incorporated in 2011 as Beijing 17173 Network Technology Co., Ltd. and was renamed on December 14, 2012. Zhi Hui You is engaged in technology development and advertising services. As of June 30, 2013,

Edgar Filing: SOHU COM INC - Form 10-Q

the registered capital of Zhi Hui You was \$1.6 million and Jing Zhou and a third party entity each held a 50% interest in this entity.

## **Table of Contents**

### Tianjin Jinhu

Tianjin Jinhu Culture Development Co., Ltd. ( Tianjin Jinhu ) was incorporated in 2011 and is engaged in advertising services. As of June 30, 2013, the registered capital of Tianjin Jinhu was \$0.5 million and Ye Deng and Chun Liu each held a 50% interest in this entity.

### Search and Others Business

### Sogou Information

Sogou Information was incorporated in 2005. As of June 30, 2013, the registered capital of Sogou Information was \$2.5 million and Xiaochuan Wang, Chief Executive Officer of Sogou, and Xianxian Hao each held a 50% interest in this entity.

### For the Online Game Business

### Gamease

Gamease was incorporated in 2007. As of June 30, 2013, the registered capital of Gamease was \$1.3 million and Tao Wang, Chief Executive Officer of Changyou, and Dewen Chen, President of Changyou, held 60% and 40% interests, respectively, in this entity.

### Shanghai ICE

Shanghai ICE was acquired by Changyou in 2010. As of June 30, 2013, the registered capital of Shanghai ICE was \$1.2 million and Runa Pi and Rong Qi each held a 50% interest in this entity.

### Guanyou Gamespace

Guanyou Gamespace was incorporated in 2010. As of June 30, 2013, the registered capital of Guanyou Gamespace was \$1.5 million and Tao Wang and Dewen Chen held 60% and 40% interests, respectively, in this entity.

### Shenzhen 7Road

68.258% of Shenzhen 7Road was acquired by Gamease in 2011. In the second quarter of 2012, in connection with a reorganization of Shenzhen 7Road to create a Cayman Islands holding company structure, Shenzhen 7Road became a VIE of 7Road, which is a Cayman Islands company of which approximately 71.926% was owned by Changyou. Shenzhen 7Road is controlled by Changyou, and Changyou is a primary beneficiary of Shenzhen 7Road, as a result of contractual arrangements among Shenzhen 7Road, 7Road Technology, which is a PRC-based indirect wholly-owned subsidiary of 7Road, and the shareholders of Shenzhen 7Road. On May 1, 2013, Gamease entered into an agreement to acquire all of the equity interests of Shenzhen 7Road held by the noncontrolling shareholders, representing 31.742% of the equity interests of Shenzhen 7Road. After closing the acquisition of noncontrolling interests on June 5, 2013, Changyou held 100% of the outstanding share capital of 7Road and Gamease held 100% equity interests of Shenzhen 7Road.

### For the Mobile Business

### GoodFeel

Beijing GoodFeel Information Technology Co., Ltd. ( GoodFeel ) was acquired in 2004 and is engaged in value added telecommunication services. As of June 30, 2013, the registered capital of GoodFeel was \$1.2 million and James Deng and Jing Zhou, held 58.1% and 41.9% interests, respectively, in this entity.

### 21 East Beijing

Beijing 21 East Culture Development Co., Ltd. ( 21 East Beijing ) was acquired in 2006. As of June 30, 2013, the registered capital of 21 East Beijing was \$1.6 million and High Century held a 100% interest in this entity.

### Yi He Jia Xun

## Edgar Filing: SOHU COM INC - Form 10-Q

Beijing Yi He Jia Xun Information Technology Co., Ltd. ( Yi He Jia Xun ) was acquired in September 2011. As of June 30, 2013, the registered capital of Yi He Jia Xun was \$2.1 million and Gang Fang and Yanfeng Lv each held a 50% interest in this entity.

**Table of Contents***Financial Information*

The following financial information of the Sohu Group's consolidated VIEs is included in the accompanying consolidated financial statements (in thousands):

	June 30, 2013	As of	December 31, 2012
<b>ASSETS:</b>			
Cash and cash equivalents	\$ 37,712	\$	62,638
Short-term investments	75,117		54,106
Accounts receivable, net	99,363		80,671
Other current assets	37,848		30,322
Intercompany receivables due from subsidiaries	159,075		109,728
<b>Total current assets</b>	<b>409,115</b>		<b>337,465</b>
Goodwill	128,396		126,516
Prepaid and other non-current assets	51,983		57,793
<b>Total assets</b>	<b>\$ 589,494</b>	<b>\$</b>	<b>521,774</b>
<b>LIABILITIES:</b>			
Accounts payable	\$ 9,449	\$	6,958
Accrued and other short-term liabilities	76,532		105,322
Receipts in advance and deferred revenue	47,505		54,150
Intercompany payables due to subsidiaries	129,243		36,446
<b>Total current liabilities</b>	<b>262,729</b>		<b>202,876</b>
<b>Other long-term liabilities</b>	<b>4,665</b>		<b>3,846</b>
<b>Total liabilities</b>	<b>\$ 267,394</b>	<b>\$</b>	<b>206,722</b>

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Net revenue	\$ 254,165	\$ 218,118	\$ 500,586	\$ 406,145
Net income	\$ 9,090	\$ 30,134	\$ 19,872	\$ 53,661

For the table below, consolidated VIEs under the Brand advertising, Sogou, Mobile and Others segments are classified as Sohu's VIEs, and consolidated VIEs under the Changyou segment are classified as Changyou's VIEs.

	Six months ended June 30,	
	2013	2012
<b>Cash flows of Sohu's VIEs</b>		
Net cash provided by/(used in) operating activities	\$ 2,795	\$ (12,169)
Net cash used in investing activities	(991)	(184)
Net cash used in financing activities	\$ 0	\$ 0

	<b>Six months ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
Cash flows of Changyou's VIEs		
Net cash provided by operating activities	\$ 28,842	\$ 11,463
Net cash used in investing activities	(55,869)	(11,291)
Net cash used in financing activities	\$ 0	\$ 0

---

## **Table of Contents**

*Summary of significant agreements currently in effect*

### **Agreements between consolidated VIEs and Nominee Shareholders**

*Loan and equity pledge agreements* between Sohu Era and the respective shareholders of High Century and Sohu Entertainment: These loan agreements provide for loans to the shareholders of High Century and Sohu Entertainment for them to make contributions to the registered capital of High Century and Sohu Entertainment in exchange for the equity interests in High Century and Sohu Entertainment, and under these pledge agreements the shareholders pledge those equity interests to Sohu Era as security for the loans. The loan agreements include powers of attorney that give Sohu Era the power to appoint nominees to act on behalf of the shareholders of High Century and Sohu Entertainment in connection with all actions to be taken by High Century and Sohu Entertainment. Pursuant to the loan agreements, the shareholders executed in blank transfers of their equity interests in High Century and Sohu Entertainment, which transfers are held by the Sohu Group's legal department and may be completed and effected at Sohu Era's election.

*Loan and equity pledge agreements* between Sogou Tech and the shareholders of Sogou Information. These loan agreements provide for loans to the shareholders of Sogou Information for them to make contributions to the registered capital of Sogou Information in exchange for the equity interests in Sogou Information, and under the pledge agreements the shareholders pledge those equity interests to Sogou Tech as security for the loans. The loans are interest free and are repayable on demand, but the shareholders can only repay the loans by transferring to Sogou Tech their equity interests in Sogou Information.

*Exclusive equity interest purchase right agreements* between Sogou Tech, Sogou Information and the shareholders of Sogou Information. Pursuant to these agreements, Sogou Tech and any third party designated by it have the right, exercisable at any time when it becomes legal to do so under PRC law, to purchase from the shareholders of Sogou Information all or any part of their equity interests at a purchase price equal to the shareholders' initial contributions to registered capital.

*Powers of Attorney* executed by the shareholders of Sogou Information in favor of Sogou Tech with a term of 10 years, extendable at the request of Sogou Tech. These powers of attorney give Sogou Tech the right to appoint nominees to act on behalf of each of the two Sogou Information shareholders in connection with all actions to be taken by Sogou Information.

*Business operation agreement* among Sogou Tech, Sogou Information and the shareholders of Sogou Information. The agreement sets forth the right of Sogou Tech to control the actions of the shareholders of Sogou Information. The agreement has a term of 10 years, renewable at the request of Sogou Tech.

*Loan agreements and equity pledge agreements* between AmazGame and the shareholders of Gamease and between Gamespace and the shareholders of Guanyou Gamespace. The loan agreements provide for loans to the shareholders of Gamease and Guanyou Gamespace, respectively, for them to make contributions to the registered capital of Gamease and Guanyou Gamespace in exchange for the equity interests in Gamease and Guanyou Gamespace, respectively. Under the equity pledge agreements the shareholders of Gamease and Guanyou Gamespace, respectively, pledge to AmazGame and Gamespace, respectively, their equity interests in Gamease and Guanyou Gamespace, respectively, to secure the performance of their obligations under the loan agreements and Gamease's and Guanyou Gamespace's obligations to AmazGame and Gamespace under their business agreements. The loans are interest free and are repayable on demand, but the shareholders can only repay the loans by transferring to AmazGame and Gamespace, respectively, their equity interests in Gamease and Guanyou Gamespace.

*Equity interest purchase right agreements* between AmazGame and the shareholders of Gamease and between Gamespace and the shareholders of Guanyou Gamespace. Pursuant to these agreements, AmazGame and Gamespace, respectively, have the right, and any third party designated by them has the right, exercisable at any time when it becomes legal to do so under PRC law, to purchase from the shareholders of Gamease and Guanyou Gamespace, respectively, all or any part of their equity interests at a purchase price equal to their initial contributions to registered capital.

*Powers of attorney* executed by the shareholders of Gamease in favor of AmazGame and the shareholders of Guanyou Gamespace in favor of Gamespace, with a term of 10 years. These powers of attorney give AmazGame and Gamespace, respectively, the exclusive right to appoint nominees to act on behalf of the shareholders in connection with all actions to be taken by Gamease and Guanyou Gamespace, respectively.

*Business operation agreements* between AmazGame and the shareholders of Gamease and between Gamespace and the shareholders of Guanyou Gamespace. This agreement sets forth the right of AmazGame and Gamespace, respectively, to control the actions of the shareholders of Gamease and Guanyou Gamespace, respectively. The agreements have a term of 10 years.





**Table of Contents**

*Call option agreement* among ICE Information, Shanghai ICE and Shanghai ICE shareholders. This agreement provides to ICE Information and any third party designated by ICE Information the right, exercisable at any time when it becomes legal to do so under PRC law, to purchase from the shareholders all or any part of their shares in Shanghai ICE or purchase from Shanghai ICE all or part of its assets or business at the lowest purchase price permissible under PRC law. The agreement is terminable only if ICE Information is dissolved.

*Share pledge agreement* among ICE Information, Shanghai ICE and the shareholders of Shanghai ICE. Under this agreement the shareholders pledge to ICE Information their equity interests in Shanghai ICE to secure the performance of their obligations under the call option agreement and Shanghai ICE's obligations to ICE Information under their business agreements.

*Business operation agreement* among ICE Information, Shanghai ICE and the shareholders of Shanghai ICE. This agreement sets forth the right of ICE Information to control the actions of the shareholders of Shanghai ICE. The agreement is terminable only if ICE Information is dissolved.

*Equity interest purchase right agreements* among 7Road Technology, Shenzhen 7Road and Shenzhen 7Road's shareholders. Under these agreements, 7Road Technology and any third-party designated by 7Road Technology have the right, exercisable at any time during the term of the agreements, if and when it is legal to do so under PRC law, to purchase from any of the Shenzhen 7Road's shareholders all or any part of their shares in Shenzhen 7Road at a nominal purchase price. Each of these agreements has a term of 10 years, is renewable by 7Road Technology for such term as it may determine and is terminable early only if Shenzhen 7Road's or 7Road Technology's existence is terminated, by mutual agreement of the parties or upon the written request of 7Road Technology.

*Equity interest pledge agreements* among 7Road Technology, Shenzhen 7Road and Shenzhen 7Road's shareholders. Under these agreements, the shareholders of Shenzhen 7Road agreed to pledge to 7Road Technology their equity interests in Shenzhen 7Road to secure the performance of their respective obligations and Shenzhen 7Road's obligations under the various VIE-related agreements. If any of the shareholders of Shenzhen 7Road or Shenzhen 7Road breaches his or its obligations under any VIE-related agreements, 7Road Technology is entitled to exercise its rights as the beneficiary under the Equity Interest Pledge Agreements. These agreements terminate only after all of the respective obligations of the shareholders and of Shenzhen 7Road under the various VIE-related agreements are no longer in effect.

*Business operation agreement* among 7Road Technology, Shenzhen 7Road and the shareholders of Shenzhen 7Road. This agreement grants to 7Road Technology the right to control the actions of Shenzhen 7Road and the shareholders of Shenzhen 7Road in their capacities as such. This agreement has a term of 10 years, is renewable by 7Road Technology for such term as it may determine and is terminable early if the existence of Shenzhen 7Road or 7Road Technology is terminated, by mutual agreement of the parties or upon the written request of 7Road Technology.

*Powers of attorney* executed by the shareholders of Shenzhen 7Road in favor of 7Road Technology. These powers of attorney give 7Road Technology the exclusive right to appoint designees to act on behalf of each of the five shareholders of Shenzhen 7Road in connection with all actions to be taken by Shenzhen 7Road requiring shareholder approval.

*Spousal Consent Letter* signed by the spouse of each of the shareholders of Shenzhen 7Road who is a married individual, in which the spouse agrees that the equity interests of Shenzhen 7Road owned by such shareholder will be disposed of only in accordance with the applicable Equity Interest Purchase Right Agreement, Equity Interest Pledge Agreement, Business Operation Agreement and other related agreements executed by the shareholder. Such spouse further agrees that such equity interests do not constitute community property with such shareholder and waives irrevocably and unconditionally all rights and benefits with respect to such equity interests, including the right to sue in any court, under all applicable law.

**Business Arrangements between Subsidiaries and consolidated VIEs**

*Business cooperation agreements* between Sohu Era and Sohu Internet and between Sogou Tech and Sogou Information. Pursuant to these agreements Sohu Era and Sogou Tech, respectively, provide technical consultation, content purchasing and other related services to Sohu Internet and Sogou Information, respectively, in exchange for a percentage of the gross income, after deduction of related costs and expenses, of Sohu Era and Sogou Tech, respectively. The agreement between Sohu Era and Sohu Internet has a term of one year, and the agreement between Sogou Tech and Sogou Information has a term of 10 years, renewable at the request of Sogou Tech.

*Exclusive technology consulting and service agreement* between Sogou Tech and Sogou Information. Pursuant to this agreement Sogou Tech has the exclusive right to provide technical consultation and other related services to Sogou Information in exchange for a certain amount of service fee, with a term of 10 years, renewable at request of Sogou Tech.

*Technology support and utilization agreements* between AmazGame and Gamease and between Gamespace and Guanyou Gamespace. Pursuant to these agreements, AmazGame and Gamespace, respectively, have the exclusive right to provide certain product development and application

## Edgar Filing: SOHU COM INC - Form 10-Q

services and technology support to Gamease and Guanyou Gamespace, respectively, for a fee equal to a predetermined percentage, subject to adjustment by AmazGame or Gamespace at any time, of Gamease's and Guanyou Gamespace's respective revenues. These agreements will be terminated only when AmazGame and Gamespace are dissolved.

---

## **Table of Contents**

*Services and maintenance agreements* between AmazGame and Gamease between Gamespace and Guanyou Gamespace. Pursuant to these agreements, AmazGame and Gamespace, respectively, provide marketing, staffing, business operation and maintenance services to Gamease and Guanyou Gamespace, respectively, in exchange for a fee equal to the cost of providing such services plus a predetermined margin. These agreements will be terminated only when AmazGame and Gamespace are dissolved.

*Exclusive business cooperation agreement* between ICE Information and Shanghai ICE. This agreement sets forth the exclusive right of ICE Information to provide business support and technical services to Shanghai ICE. The agreement will be terminated only when ICE Information is dissolved.

*Exclusive technology consulting and services agreement* between ICE Information and Shanghai ICE. This agreement provides to ICE Information the exclusive right to provide technical consultation and other related services to Shanghai ICE in exchange for a fee equal to the balance of Shanghai ICE's gross income after deduction of related costs and expenses. The agreement will be terminated only when ICE Information is dissolved.

*Technology development and utilization agreement* between 7Road Technology and Shenzhen 7Road. Under this agreement, 7Road Technology has the exclusive right to provide product development and application services and technology support to Shenzhen 7Road for a fee based on Shenzhen 7Road's revenues, which fee can be adjusted by 7Road Technology at any time in its sole discretion. The fee is eliminated upon consolidation. This agreement will terminate if the existence of 7Road Technology or Shenzhen 7Road is terminated, by mutual agreement of the parties or upon failure to perform due to a force majeure event.

*Services and maintenance agreement* between 7Road Technology and Shenzhen 7Road. Pursuant to this agreement, 7Road Technology provides marketing and maintenance services to Shenzhen 7Road in exchange for a fee equal to the cost of providing such services plus a predetermined margin. This agreement will terminate if the existence of 7Road Technology or Shenzhen 7Road is terminated, by mutual agreement of the parties or upon failure to perform due to a force majeure event.

Certain of the contractual arrangements described above between the VIEs and the related wholly-owned subsidiaries of the Sohu Group are silent regarding renewals. However, because the VIEs are controlled by the Sohu Group through powers of attorney granted to the Sohu Group by the shareholders of the VIEs, the contractual arrangements can be, and are expected to be, renewed at the subsidiaries' election.

### ***VIE-Related Risks***

It is possible that the Sohu Group's operation of certain of its operations and businesses through VIEs could be found by PRC authorities to be in violation of PRC laws and regulations prohibiting or restricting foreign ownership of companies that engage in such operations and businesses. If such a finding were made, regulatory authorities with jurisdiction over the licensing and operation of such operations businesses would have broad discretion in dealing with such a violation, including levying fines, confiscating the Group's income, revoking the business or operating licenses of the affected businesses, requiring the Group to restructure its ownership structure or operations, or requiring the Group to discontinue all or any portion of its operations. Any of these actions could cause significant disruption to the Group's business operations, and have a materially adverse impact on the Group's cash flows, financial position and operating performance. The management considers the possibility of such a finding by PRC regulatory authorities to be remote.

In addition, it is possible that the contracts with the Sohu Group, the Sohu Group's VIEs and shareholders of its VIEs would not be enforceable in China if PRC government authorities or courts were to find that such contracts contravene PRC laws and regulations or are otherwise not enforceable for public policy reasons. In the event that the Sohu Group was unable to enforce these contractual arrangements, the Group would not be able to exert effective control over the affected VIEs. Consequently, such VIE's results of operations, assets and liabilities would not be included in the Sohu Group's consolidated financial statements. If such were the case, the Group's cash flows, financial position and operating performance would be materially adversely affected. The Sohu Group's contractual arrangements with respect to its consolidated VIEs are approved and in place. The management believes that such contracts are enforceable, and considers the possibility remote that PRC regulatory authorities with jurisdiction over the Sohu Group's operations and contractual relationships would find the contracts to be unenforceable.

**Table of Contents*****VIE Not Consolidated within the Sohu Group***

In December 2012, the Sohu Group acquired, for a price of \$1.6 million, a 25% equity interest in a VIE to support the Group's brand advertising business. Since the Sohu Group neither controls nor has significant influence over this VIE, the Group is not the primary beneficiary and, accordingly, the Group recognizes the investment under the equity method. In assessing its maximum exposure to a loss on the investment compared to the cost of its investment, the Sohu Group determined that it did not have further obligations exceeding the cost of the investment and that there were no terms of the investment arrangement that could require the Sohu Group to provide further financial support to the VIE.

**10. Sohu.com Inc. Shareholders' Equity*****Takeover Defense***

Sohu intends to adopt appropriate defensive measures in the future on a case by case basis as and to the extent that Sohu's Board of Directors determines that such measures are necessary or advisable to protect Sohu stockholder value in the face of any coercive takeover threats or to prevent an acquirer from gaining control of Sohu without offering fair and adequate price and terms.

***Treasury Stock***

Treasury stock consists of shares repurchased by Sohu that are no longer outstanding and are held by Sohu. Treasury stock is accounted for under the cost method.

On August 29, 2011, Sohu's Board of Directors authorized a combined share purchase program of up to \$100 million of outstanding shares of common stock of Sohu and/or the outstanding American depositary shares (ADSs) of Changyou over a one-year period from September 1, 2011 to August 31, 2012. As of the expiration of the program on August 31, 2012, Sohu had repurchased 500,000 shares of common stock of Sohu, which is treated as treasury stock, for consideration of \$29.2 million. The Group also had purchased 750,000 Changyou ADSs, representing 1,500,000 ordinary shares, for consideration of \$25.7 million. The total consideration paid under the combined share purchase program was \$54.9 million.

***Stock Incentive Plan***

Sohu, Changyou, Sogou, Sohu Video and 7Road all have incentive plans for the granting of share-based awards, including common stock/ordinary shares, share options, restricted shares and restricted share units, to their directors, executive officers, and employees.

***1) Sohu.com Inc. Share-based Awards*****Sohu's 2000 Stock Incentive Plan**

Sohu's 2000 Stock Incentive Plan (the "Sohu 2000 Stock Incentive Plan") provided for the issuance of up to 9,500,000 shares of common stock, including those issued pursuant to the exercise of share options and upon vesting and settlement of restricted share units. Most of these awards vest over a period of four years. The maximum term of any issued stock right under the Sohu 2000 Stock Incentive Plan is ten years from the grant date. The Sohu 2000 Stock Incentive Plan expired on January 24, 2010. As of the expiration date, 9,128,724 shares of common stock had been issued or were subject to issuance upon the vesting and exercise of share options or the vesting and settlement of restricted share units granted under the plan. A new plan (the "Sohu 2010 Stock Incentive Plan") was adopted on July 2, 2010.

For the three and six months ended June 30, 2013, total share-based compensation expense recognized for awards under the Sohu 2000 Stock Incentive Plan was \$0.5 million and \$1.2 million, respectively. For the three and six months ended June 30, 2012, total share-based compensation expense recognized for awards under the Sohu 2000 Stock Incentive Plan was \$1.2 million and \$2.7 million, respectively.

**Table of Contents**

## i) Summary of share option activity

A summary of share option activity under the Sohu 2000 Stock Incentive Plan as of and for the six months ended June 30, 2013 is presented below:

<b>Options</b>	<b>Number Of Shares (in thousands)</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Aggregate Intrinsic Value (1) (in thousands)</b>
Outstanding at January 1, 2013	242	\$ 19.36	1.91	\$ 6,781
Exercised	(57)	14.53		
Forfeited or expired	(1)	9.07		
Outstanding at June 30, 2013	184	20.91	1.67	7,478
Vested at June 30, 2013	184	20.91	1.67	7,478
Exercisable at June 30, 2013	184	20.91	1.67	7,478

Note (1): The aggregate intrinsic value in the preceding table represents the difference between Sohu's closing stock price of \$61.62 on June 30, 2013 and the exercise price of share options. The total intrinsic value of share options exercised for the six months ended June 30, 2013 was \$2.0 million.

No options have been granted under Sohu's 2000 Stock Incentive Plan since 2006. For the three and six months ended June 30, 2013 and 2012, no compensation expense was recognized for share options because the requisite service periods for share options had ended by the end of 2009.

For the three and six months ended June 30, 2013, total cash received from the exercise of share options amounted to \$0.3 million and \$0.8 million, respectively. For the three and six months ended June 30, 2012, total cash received from the exercise of share options amounted to \$99,000 and \$139,000, respectively.

## ii) Summary of restricted share unit activity

A summary of restricted share unit activity under the Sohu 2000 Stock Incentive Plan as of and for the six months ended June 30, 2013 is presented below:

<b>Restricted Share Units</b>	<b>Number of Units (in thousands)</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Unvested at January 1, 2013	255	\$ 61.27
Granted	0	
Vested	(127)	61.27
Forfeited	(2)	61.27
Unvested at June 30, 2013	126	61.27
Expected to vest thereafter	94	61.27

## Edgar Filing: SOHU COM INC - Form 10-Q

For the three and six months ended June 30, 2013, total share-based compensation expense recognized for restricted share units was \$0.5 million and \$1.2 million, respectively. For the three and six months ended June 30, 2012, total share-based compensation expense recognized for restricted share units was \$1.2 million and \$2.7 million, respectively.

As of June 30, 2013, there was \$1.2 million of unrecognized compensation expense related to unvested restricted share units. The expense is expected to be recognized over a weighted average period of 0.41 years. The total fair value on their respective vesting dates of restricted share units vested during the three and six months ended June 30, 2013 was nil and \$6.2 million, respectively. The total fair value on their respective vesting dates of restricted share units vested during the three and six months ended June 30, 2012 was \$0.3 million and \$8.9 million, respectively.

### Sohu's 2010 Stock Incentive Plan

On July 2, 2010, Sohu adopted the Sohu 2010 Stock Incentive Plan, which provides for the issuance of up to 1,500,000 shares of common stock, including those issued pursuant to the vesting and settlement of restricted share units and pursuant to the exercise of share options. The maximum term of any issued stock right under the Sohu 2010 Stock Incentive Plan is ten years from the grant date. The Sohu 2010 Stock Incentive Plan will expire on July 1, 2020. As of June 30, 2013, 1,455,422 shares were available for grant under the Sohu 2010 Stock Incentive Plan.

**Table of Contents**

A summary of restricted share unit activity under the Sohu 2010 Stock Incentive Plan as of and for the six months ended June 30, 2013 is presented below:

<b>Restricted Share Units</b>	<b>Number of Units (in thousands)</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Unvested at January 1, 2013	5	\$ 70.88
Granted	14	48.75
Vested	0	
Forfeited	(2)	70.88
<b>Unvested at June 30, 2013</b>	<b>17</b>	<b>52.97</b>
Expected to vest thereafter	16	51.99

For the three and six months ended June 30, 2013, total share-based compensation expense recognized for restricted share units was \$0.2 million and \$0.4 million, respectively. For the three and six months ended June 30, 2012, total share-based compensation expense recognized for restricted share units was \$0.2 million and \$0.4 million, respectively.

As of June 30, 2013, there was \$0.5 million of unrecognized compensation expense related to unvested restricted share units. The expense is expected to be recognized over a weighted average period of 0.48 years. The total fair value on their respective vesting dates of restricted share units vested was nil during the three and six months ended June 30, 2013 and during the three and six months ended June 30, 2012.

## 2) *Changyou.com Limited Share-based Awards*

### Changyou's 2008 Share Incentive Plan

Changyou's 2008 Share Incentive Plan (the "Changyou 2008 Share Incentive Plan") originally provided for the issuance of up to 2,000,000 ordinary shares, including those issued pursuant to the exercise of share options and upon vesting and settlement of restricted share units. In March 2009, the 2,000,000 reserved ordinary shares were subject to a ten-for-one share split effected by Changyou and became 20,000,000 ordinary shares. Most of these awards vest over a period of four years. The maximum term of any issued share right under the Changyou 2008 Share Incentive Plan is ten years from the grant date. The Changyou 2008 Share Incentive Plan will expire in August 2018.

As of June 30, 2013, Changyou had granted under the Changyou 2008 Share Incentive Plan 15,000,000 ordinary shares to Tao Wang, through Prominence Investments Ltd. ("Prominence") and 4,781,552 restricted share units to certain of its executive officers other than Tao Wang, and to certain of its other employees. Prominence is an entity that may be deemed under applicable rules of the Securities and Exchange Commission to be beneficially owned by Tao Wang.

For the three and six months ended June 30, 2013, total share-based compensation expense recognized for awards under the Changyou 2008 Share Incentive Plan was \$0.4 million and \$0.6 million, respectively. For the three and six months ended June 30, 2012, total share-based compensation expense recognized for awards under the Changyou 2008 Share Incentive Plan was \$0.8 million and \$2.0 million, respectively.

### Share-based Awards granted before Changyou's Initial Public Offering

For Changyou restricted ordinary shares granted to Tao Wang and to its executive officers other than Tao Wang before Changyou's initial public offering, there was no unrecognized share-based compensation expense as of June 30, 2013, as these awards were fully vested in 2012.

For Changyou restricted share units granted to certain of its other employees before Changyou's initial public offering, there was no unrecognized share-based compensation expense as of June 30, 2013, as these awards were fully vested. The fair value of these restricted share units as of the grant date was determined based on Changyou's offering price for its initial public offering, which was \$8.00 per ordinary share.

A summary of activity for the restricted share units as of and for the six months ended June 30, 2013 is presented below:



<b>Restricted Share Units</b>	<b>Number of Units (in thousands)</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Unvested at January 1, 2013	81	\$ 8.00
Granted	0	
Vested	(81)	8.00
Forfeited	0	
Unvested at June 30, 2013	0	
Expected to vest thereafter	0	

**Table of Contents**

For the three and six months ended June 30, 2013, total share-based compensation expense recognized for the above restricted share units was nil and negative \$0.3 million, respectively. The negative \$0.3 million resulted from Changyou's true-up of the share-based compensation expense for forfeited restricted share units in the first quarter of 2013. For the three and six months ended June 30, 2012, total share-based compensation expense recognized for the above restricted share units was \$50,000 and \$0.2 million, respectively.

As of June 30, 2013, there was no unrecognized share-based compensation expense related to the unvested restricted share units. The total fair value of restricted share units vested to Changyou's employees on their respective vesting dates was \$1.1 million both for the three months and for the six months ended June 30, 2013. The total fair value of restricted share units vested to Changyou's employees on their respective vesting dates was \$1.2 million both for the three months and for the six months ended June 30, 2012.

**Share-based Awards granted after Changyou's Initial Public Offering**

As of June 30, 2013, in addition to the share-based awards granted before Changyou's initial public offering, Changyou had granted an aggregate of 1,585,552 restricted share units (setttable in ordinary shares) to certain of its executive officers other than Tao Wang and to certain of its employees. These restricted share units are subject to vesting over a four-year period commencing on their grant dates. Share-based compensation expense for such restricted share units is recognized on an accelerated basis over the requisite service period. The fair value of restricted share units was determined based on the market price of Changyou's ADSs on the grant date.

A summary of activity for these restricted share units as of and for the six months ended June 30, 2013 is presented below:

<b>Restricted Share Units</b>	<b>Number of Units (in thousands)</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Unvested at January 1, 2013	526	\$ 13.30
Granted	36	14.57
Vested	(319)	12.70
Forfeited	(10)	12.11
Unvested at June 30, 2013	233	14.37
Expected to vest thereafter	215	14.40

For the three and six months ended June 30, 2013, total share-based compensation expense recognized for the above restricted share units was \$0.4 million and \$0.9 million, respectively. For the three and six months ended June 30, 2012, total share-based compensation expense recognized for the above restricted share units was \$0.8 million and \$1.8 million, respectively.

As of June 30, 2013, there was \$1.3 million of unrecognized compensation expense related to the unvested restricted share units. The expense is expected to be recognized over a weighted average period of 0.92 years. The total fair value of these restricted share units vested during the three and six months ended June 30, 2013 was \$4.4 million and \$4.7 million, respectively. The total fair value of these restricted share units vested during the three and six months ended June 30, 2012 was \$3.7 million and \$4.0 million, respectively.

**3) Sogou Inc. Share-based Awards****Sogou 2010 Share Incentive Plan**

On October 20, 2010, Sogou adopted the Sogou 2010 Share Incentive Plan (the "Sogou 2010 Share Incentive Plan"). On June 18, 2013, the Sogou 2010 Share Incentive Plan was amended to provide for the issuance of up to 36,000,000 ordinary shares of Sogou to management and key employees of Sogou and of any present or future parents or subsidiaries or variable interest entities of Sogou. The maximum term of any issued share right under the amended Sogou 2010 Share Incentive Plan is ten years from the grant date. The amended Sogou 2010 Share Incentive Plan will expire on October 19, 2020. As of June 30, 2013, Sogou had issued options for the purchase of 35,654,750 ordinary shares.

Of the 35,654,750 issued share options, 23,424,750 share options will become vested and exercisable in four equal installments, with each installment vesting upon a service period requirement for management and key employees being met, as well as Sogou's achievement of

## Edgar Filing: SOHU COM INC - Form 10-Q

performance targets for the corresponding period. The performance target for each installment will be set at the beginning of each vesting period; therefore, for purposes of recognition of share-based compensation expense, each installment is considered to be granted at that date. As of June 30, 2013, performance targets had been set for 12,960,400 share options and, accordingly, those options subject to vesting upon service period requirements for management and key employees being met and Sogou's achievement of performance targets were considered granted for purposes of recognition of share-based compensation expense. As of June 30, 2013, 9,944,125 share options had become vested and exercisable because both the service period and the performance requirements had been met, and a portion of the vested shares had been exercised. 108,150 share options, for which the performance requirements had been met, remained unvested because the service period requirement had not been met.

**Table of Contents**

8,270,000 share options will become vested and exercisable in four or five equal installments, with (i) the first installment vesting upon Sogou's completion of an initial public offering of its ordinary shares ( Sogou's IPO ) and the expiration of all underwriters' lockup periods applicable to the IPO, and (ii) each of the three or four subsequent installments vesting on the first, second, third and, if applicable, fourth anniversary dates, respectively, of the closing of Sogou's IPO.

The remaining 3,960,000 share options will become vested and exercisable in four equal installments, with (i) the first installment vesting upon the first anniversary of the occurrence of either of the following events ( Event ): (a) completion of Sogou's IPO; (b) the consolidation of Sogou with or the acquisition of Sogou by another person or entity in a sale of all or substantially all of its assets or shares, and (ii) each of the three subsequent installments vesting on the second, third and fourth anniversary dates, respectively, of the occurrence of an Event. If there has not been an Event within 24 months from June 15, 2013 (the Vesting Cessation Date ), all installments of the remaining 3,960,000 share options will cease to vest.

All installments of the 8,270,000 and 3,960,000 share options that are subject to vesting upon the completion of Sogou's IPO or an Event were considered granted upon the issuance of the options. The completion of a firm commitment IPO or such an Event is considered to be a performance condition of the awards. An IPO event or such an Event is not considered to be probable until it is completed. Under ASC 718, compensation cost should be accrued if it is probable that the performance condition will be achieved and should not be accrued if it is not probable that the performance condition will be achieved. As a result, no compensation expense will be recognized related to these options until the completion of an IPO or the occurrence of an Event, and hence no share-based compensation expense was recognized for the three and six months ended June 30, 2013 for the 8,270,000 and 3,960,000 share options that are subject to vesting upon the completion of Sogou's IPO or an Event.

A summary of share option activity under the Sogou 2010 Stock Incentive Plan as of and for the six months ended June 30, 2013 is presented below:

<b>Options</b>	<b>Number Of Shares (in thousands)</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>
Outstanding at January 1, 2013	6,345	\$ 0.001	
Granted	14,168	0.318	
Exercised	(5,121)	0.001	
Forfeited or expired	(17)	0.001	
<b>Outstanding at June 30, 2013</b>	<b>15,375</b>	<b>0.293</b>	<b>9.34</b>
Vested at June 30, 2013 and expected to vest thereafter	3,063		
<b>Exercisable at June 30, 2013</b>	<b>128</b>		

For the three and six months ended June 30, 2013, total share-based compensation expense recognized for share options under the amended Sogou 2010 Share Incentive Plan was \$132,000 and \$148,000, respectively. For the three and six months ended June 30, 2012, total share-based compensation expense recognized for share options under the amended Sogou 2010 Share Incentive Plan was \$956,000 and \$977,000, respectively.

As of June 30, 2013, there was \$1.8 million of unrecognized compensation expense related to the unvested share options. The expense is expected to be recognized over a weighted average period of 0.51 years.

The fair value of the ordinary shares of Sogou was assessed using the income approach /discounted cash flow method, with a discount for lack of marketability, given that the shares underlying the award were not publicly traded at the time of grant, and was determined with the assistance of a qualified professional appraiser using management's estimates and assumptions. This assessment required complex and subjective judgments regarding Sogou's projected financial and operating results, its unique business risks, the liquidity of its ordinary shares and its operating history and prospects at the time the grants were made.

## Edgar Filing: SOHU COM INC - Form 10-Q

The fair value of the options granted to Sogou management and key employees was estimated on the date of grant using the Binomial option - pricing model (the BP Model ) with the following assumptions used:

<b>Granted to Employees</b>	<b>2013</b>
Average risk-free interest rate	2.10%~2.51%
Exercise multiple	2~3
Expected forfeiture rate (Post-vesting)	1.3%~6.0%
Weighted average expected option life	10
Volatility rate	47.00%~49.00%
Dividend yield	0%
Fair value	0.67

**Table of Contents**

Sogou estimated the risk free rate based on the yield to maturity of China Sovereign bonds denominated in United States dollars as of the valuation date. An exercise multiple was estimated as the ratio of fair value of the shares over the exercise price as of the time the option is exercised, based on consideration of research studies regarding exercise patterns based on historical statistical data. In Sogou's valuation analysis, a multiple of two was applied for employees and a multiple of three was applied for management. Sogou estimated the forfeiture rate to be 1.3% for Sogou management's share options granted as of June 30, 2013 and 6.0% for Sogou employees' share options granted as of June 30, 2013. The life of the share options is the contract life of the option. Based on the option agreement, the contract life of the option is 10 years. The expected volatility at the valuation date was estimated based on the historical volatility of comparable companies for the period before the grant date with length commensurate with the expected term of the options. Sogou has no history or expectation of paying dividends on its ordinary shares. Accordingly, the dividend yield is estimated to be 0%.

**Share-based Awards to Sohu management**

Under an arrangement approved by the Board of Directors of Sohu and Sogou in March 2011, Sohu has the right to provide to Sohu management and key employees the opportunity to purchase from Sohu up to 12,000,000 ordinary shares of Sogou at a fixed exercise price of \$0.625 per share. Of these 12,000,000 ordinary shares, 8,800,000 are Sogou ordinary shares previously held by Sohu and 3,200,000 are Sogou ordinary shares that were newly-issued on April 14, 2011 by Sogou to Sohu at a price of \$0.625 per share, or a total of \$2 million. As of June 30, 2013, Sohu had issued options for the purchase of 11,378,500 Sogou ordinary shares to Sohu management and key employees under this arrangement.

Of the 11,378,500 issued share options, 8,978,500 share options will become vested and exercisable in four equal installments, with each installment vesting upon a service period requirement for management and key employees being met, as well as Sogou's achievement of performance targets for the corresponding period. The performance target for each installment will be set at the beginning of each vesting period; therefore, for purposes of recognition of share-based compensation expense, each installment is considered to be granted at that date. As of June 30, 2013, performance targets had been set for 5,466,875 share options and, accordingly, those options vesting upon service period requirements for management and key employees being met and Sogou's achievement of performance targets were considered granted. As of June 30, 2013, 4,348,000 share options had become vested and exercisable because both the service period and the performance requirements had been met, and a portion of the vested shares had been exercised.

The remaining 2,400,000 share options will become vested and exercisable in five equal installments, with (i) the first installment vesting upon Sogou's IPO and the expiration of all underwriters' lockup periods applicable to the IPO, and (ii) each of the four subsequent installments vesting on the first, second, third and fourth anniversary dates, respectively, of the closing of Sogou's IPO. All installments of the 2,400,000 share options that are subject to vesting upon the completion of Sogou's IPO were considered granted upon the issuance of the options. The completion of a firm commitment IPO is considered to be a performance condition of the awards. An IPO event is not considered to be probable until it is completed. Under *ASC 718*, compensation cost should be accrued if it is probable that the performance condition will be achieved and should not be accrued if it is not probable that the performance condition will be achieved. As a result, no compensation expense will be recognized related to these options until the completion of an IPO, and hence no share-based compensation expense was recognized for the three and six months ended June 30, 2013, for the 2,400,000 share options that are subject to vesting upon the completion of Sogou's IPO.

A summary of share option activity as of and for the six months ended June 30, 2013 is presented below:

	Number Of Shares (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
Options Outstanding at January 1, 2013	2,178	\$ 0.625	
Granted	3,519	0.625	
Exercised	(2,175)	0.625	
Forfeited or expired	0		
Outstanding at June 30, 2013	3,522	0.625	9.11
Vested at June 30, 2013 and expected to vest thereafter	1,119		

Exercisable at June 30, 2013

3

32

**Table of Contents**

For both the three months and the six months ended June 30, 2013, total share-based compensation expense recognized for share options under the arrangement was \$22,000. For both the three months and the six months ended June 30, 2012, total share-based compensation expense recognized for share options under the arrangement was \$182,000.

As of June 30, 2013, there was \$361,000 of unrecognized compensation expense related to the unvested share options. The expense is expected to be recognized over a weighted average period of 0.5 years.

The method used to determine the fair value of share options granted to Sohu management and key employees was the same as the method used for the share options granted to Sogou's management and key employees as described above, except for the assumptions used in the BP Model as presented below:

<b>Granted to Employees</b>	<b>2013</b>
Average risk-free interest rate	2.10%~2.51%
Exercise multiple	2~3
Expected forfeiture rate (Post-vesting)	0%-8%
Weighted average expected option life	10
Volatility rate	48.00%-49.00%
Dividend yield	0%
Fair value	0.27-0.38

**Option Modification**

As of June 30, 2013, 19,245,000 share options granted under the amended Sogou 2010 Share Incentive Plan and 1,225,000 share options granted under the arrangement providing for Sogou share-based awards to Sohu management and key employees, or a total of 20,470,000 share options, were early exercised, and the resulting Sogou ordinary shares were transferred to a trust with the original option grantees as beneficiaries. The trust will distribute the shares to those beneficiaries in installments based on the vesting requirements under the original option agreements. Although this trust arrangement caused a modification of the terms of these share options, the modification was not considered substantive; therefore no incremental fair value related to these shares resulted from the modification, and the remaining share-based compensation expense for these shares will continue to be recognized over the original remaining vesting period.

***4) Sohu Video Share-based Awards and 7Road Share-based Awards***

See Note 3 - Share-Based Compensation Expense.

**11. Business Restructuring*****7Road Transactions***

On May 11, 2011, Changyou, through its VIE Gamease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road's financial statements on June 1, 2011. Effective June 26, 2012, Shenzhen 7Road was reorganized into a Cayman Islands holding company structure where Changyou holds a direct ownership interest in 7Road through Changyou's subsidiary Changyou.com Webgames (HK) Limited, and Shenzhen 7Road is a VIE of 7Road. On June 21, 2012, Mr. Kai Cao, who was then 7Road's Chief Executive Officer, surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the then outstanding share capital of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou's interest in 7Road increased to 71.926%. When 7Road and Shenzhen 7Road are discussed in this report, the reorganization is treated as if it had been effective upon Changyou's initial acquisition of the equity interests of Shenzhen 7Road.

On May 1, 2013, Changyou entered into an agreement to acquire all of the ordinary shares of 7Road held by the noncontrolling shareholders, representing 28.074% of the outstanding share capital of 7Road, for aggregate cash consideration of approximately \$78 million. Effective with Changyou's entering into the acquisition agreement, Mr. Dewen Chen, Changyou's President, was appointed as the Chairman and acting Chief Executive Officer of 7Road, and Mr. Kai Cao resigned as a director and as Chief Executive Officer of 7Road.



## Edgar Filing: SOHU COM INC - Form 10-Q

The acquisition closed on June 5, 2013. Effective with the closing, 7Road became an indirect wholly-owned subsidiary of Changyou, and Changyou's VIE Gamease became the sole shareholder of 7Road's VIE Shenzhen 7Road. Also effective upon the closing, the former noncontrolling shareholders' existing non-compete covenants with Changyou were terminated, and an agreement took effect under which the former noncontrolling shareholders agreed, for a period of two years after the closing, to not solicit or hire existing employees of 7Road.

---

**Table of Contents**

As of June 30, 2013, Changyou had paid \$76 million of the total cash consideration. The remaining \$2 million will be settled in June 2014.

***17173 Transaction***

On December 15, 2011, Sohu closed the sale to Changyou of certain assets associated with the business of 17173.com (the 17173 Business ) for fixed cash consideration of \$162.5 million. After the closing of the sale, Sohu continued to consolidate the results of operations of the 17173 Business in the Sohu Group s consolidated financial statements.

***Sogou Transactions***

***Sogou Restructuring***

On October 22, 2010, Sogou sold 24.0 million, 14.4 million and 38.4 million, respectively, of its newly-issued Series A Preferred Shares to Alibaba Investment Limited ( Alibaba ), a private investment subsidiary of Alibaba Group Holding Limited, China Web Search (HK) Limited ( China Web ), an investment vehicle of Yunfeng Fund, LP, and Photon Group Limited ( Photon ), the investment fund of Dr. Charles Zhang, for \$15 million, \$9 million, and \$24 million, respectively.

On June 29, 2012, Sohu purchased the 24 million Sogou Series A Preferred Shares from Alibaba for fixed cash consideration of \$25.8 million. Under ASC 810-10, changes in a parent s ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. The \$14.2 million excess of the purchase price over Alibaba s net investment balance reduced additional paid-in capital in the Sohu Group s consolidated balance sheets.

***Sohu s Shareholding in Sogou***

**Shareholding Control and Economic Interest**

As of June 30, 2013, Sogou had outstanding a combined total of 225,763,006 ordinary shares and Series A preferred shares, of which Sohu held 134,868,250 ordinary shares and 24,000,000 Series A preferred shares, or approximately 70% of the combined total of Sogou s outstanding ordinary shares and Series A preferred shares. Of the 158,868,250 shares held by Sohu, 7,668,250 ordinary shares are subject to purchase under options held by Sohu management and key employees. The remaining 151,200,000 shares account for 67% of the combined total of Sogou s outstanding ordinary shares and Series A preferred shares. As Sogou s controlling shareholder, Sohu continues to consolidate Sogou in the Sohu Group s consolidated financial statements, but recognizes noncontrolling interest reflecting economic interests in Sogou held by shareholders other than Sohu.

Sohu s economic interest in Sogou, as well as the noncontrolling interest recognized for Sogou in the Sohu Group s consolidated financial statements, will continue to change as Sogou generates profit /(loss), and outstanding Sogou share options become vested and settled.

**Dilutive Impact**

As of June 30, 2013, a portion of Sogou options granted to Sogou and Sohu top management and key employees were still unvested and were settable upon the achievement of different vesting conditions. Because no ordinary shares will be issued with respect to share options granted by Sogou until they are vested and exercised, the share options granted by Sogou that have not vested and vested share options that have not yet been exercised are not included as outstanding shares of Sogou and have no impact on the Sohu Group s basic net income per share. Unvested share options with the performance targets achieved and vested share options that have not yet been exercised do, however, have a dilutive impact on the Sohu Group s dilutive net income per share. See Note 14 - Net Income per Share.

***Sogou Series A Terms***

The following is a summary of some of the key terms of the Sogou Series A Preferred Shares.

## **Table of Contents**

### **Dividend Rights**

Sogou may not declare or pay dividends on its ordinary shares unless the holders of the Series A Preferred Shares then outstanding first receive a dividend on each outstanding Series A Preferred Share in an amount at least equal to the sum of (i) the dividends that would have been payable to the holder of such Series A Preferred Share if such share had been converted into ordinary shares, at the then-applicable conversion rate, immediately prior to the record date for such dividend, and (ii) all accrued and unpaid Accruing Dividends. Accruing Dividends are calculated from the date of issuance of the Series A Preferred Shares at the rate per annum of \$0.0375 per Series A Preferred Share.

### **Liquidation Rights**

In the event of any Liquidation Event, such as the liquidation, dissolution or winding up of Sogou, a merger or consolidation of Sogou resulting in a change of control, the sale of substantially all of Sogou's assets or similar events, the holders of Series A Preferred Shares are entitled to receive, before any payment to holders of ordinary shares, an amount equal to the greater of (i) 1.3 times their original investment in the Series A Preferred Shares plus all accrued but unpaid Accruing Dividends and any other accrued and unpaid dividends on the Series A Preferred Shares or (ii) such amount per share as would be payable if the Series A Preferred Shares had been converted into ordinary shares, at the then-applicable conversion rate, immediately prior to the Liquidation Event.

### **Redemption Rights**

The Series A Preferred Shares are not redeemable.

### **Conversion Rights**

Each Series A Preferred Share is convertible, at the option of the holder, at any time, and without the payment of additional consideration by the holder. Each Series A Preferred Share is convertible into such number of ordinary shares as is determined by dividing the original issue price of Series A Preferred Share by the then-effective conversion price. The conversion price is initially the same as the original issue price of \$0.625, and is subject to adjustment on a weighted average basis upon the issuance of additional equity shares, or securities convertible into equity shares, at a price per share less than the original price per share of the Series A Preferred Shares, subject to certain customary exceptions, such as shares issued pursuant to the amended Sogou 2010 Share Incentive Plan. Each Series A Preferred Share will be automatically converted into ordinary shares of Sogou upon the closing of a qualified initial public offering of Sogou based on the then-effective conversion price.

### **Voting Rights**

Each holder of Series A Preferred Shares is entitled to cast the number of votes equal to the number of ordinary shares into which the Series A Preferred Shares held by such holder are then convertible.

### **Other Rights**

The Series A Terms include various other provisions typical of preferred share investments, such as rights of first refusal and co-sale, and registration rights.

### **Changyou Transactions**

On April 7, 2009, Changyou completed an initial public offering of its ADSs on the NASDAQ Global Select Market under the symbol CYOU. Each of Changyou's ADS represents two ordinary shares.

As of June 30, 2013, Sohu held approximately 67% of the combined total of Changyou's outstanding ordinary shares and controlled approximately 81% of the total voting power in Changyou. As Changyou's controlling shareholder, Sohu continues to consolidate Changyou in the Sohu Group's consolidated financial statements but recognizes noncontrolling interest reflecting the economic interest in Changyou held by shareholders other than Sohu.

As of June 30, 2013, Changyou had outstanding a combined total of 284,338 restricted share units. Because no ordinary shares will be issued with respect to these restricted share units until the restricted share units are vested and settled, the unvested restricted share units and vested restricted share units that have not yet been settled are not included as outstanding shares of Changyou and have no impact on the Sohu Group's basic net income per share. Unvested restricted share units and vested restricted share units that have not yet been settled do, however, have a

Edgar Filing: SOHU COM INC - Form 10-Q

dilutive impact on the Sohu Group's diluted net income per share. See Note 14 - Net Income per Share.

---

## **Table of Contents**

### **12. Mezzanine Equity**

On May 11, 2011, Changyou, through its VIE Gamease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road's financial statements on June 1, 2011.

On June 21, 2012, 7Road's then Chief Executive Officer surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the then outstanding share capital of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou's interest in 7Road increased to 71.926%.

Mezzanine Equity consists of noncontrolling interest in 7Road and a put option pursuant to which the noncontrolling shareholders would have the right to put their ordinary shares in 7Road to Changyou at a pre-determined price if 7Road achieved specified performance milestones before the expiration of the put option and 7Road did not complete an IPO on NASDAQ, the NYSE or the HKEX. The put option was due to expire in 2014. Since the occurrence of the sale was not solely within the control of Changyou, the noncontrolling interest was classified as mezzanine equity instead of permanent equity in the Sohu Group's and Changyou's consolidated financial statements.

Under *ASC 480-10*, the Sohu Group calculates, on an accumulative basis from the acquisition date, (i) the amount of accretion that would increase the balance of noncontrolling interest to its estimated redemption value over the period from the date of the Shenzhen 7Road acquisition to the earliest redemption date of the noncontrolling interest in 7Road and (ii) the amount of net profit attributable to noncontrolling shareholders of 7Road based on their ownership percentage. The carrying value of the noncontrolling interest as mezzanine equity is adjusted by an accumulative amount equal to the higher of (i) and (ii).

On May 1, 2013, Changyou entered into an agreement to acquire all of the ordinary shares of 7Road held by the noncontrolling shareholders. The acquisition closed on June 5, 2013. See Note 11 - Business Restructuring. Under *ASC 810-10*, changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. Following the closing of the acquisition, \$2.4 million, representing the excess of the amount of the mezzanine-classified noncontrolling interest in 7Road over the purchase price as of the closing date, was recorded in the Sohu Group's equity accounts.

For the three and six months ended June 30, 2013, accretion charges of \$7.1 million and \$17.8 million, respectively, compared to \$1.1 million and \$2.2 million, respectively, for the three and six months ended June 30, 2012, were recorded in the Sohu Group's statements of comprehensive income as net income attributable to the mezzanine-classified noncontrolling interest shareholders of 7Road.

### **13. Noncontrolling Interest**

The primary majority-owned subsidiaries and VIEs of the Sohu Group which are consolidated in its consolidated financial statements but with noncontrolling interest recognized are Changyou and Sogou.

#### ***Noncontrolling Interest for Changyou***

As Sohu is Changyou's controlling shareholder, Changyou's financial results have been consolidated with those of Sohu for all periods presented. To reflect the economic interest in Changyou held by shareholders other than Sohu (the noncontrolling shareholders), Changyou's net income attributable to these noncontrolling shareholders is recorded as noncontrolling interest in the Sohu Group's consolidated statements of comprehensive income, based on their share of the economic interest in Changyou. Changyou's cumulative results of operations attributable to these noncontrolling shareholders, along with changes in shareholders' equity, adjustment for share-based compensation expense in relation to those share-based awards which are unvested and vested but not yet settled and adjustment for changes in Sohu's ownership in Changyou, are recorded as noncontrolling interest in the Sohu Group's consolidated balance sheets.

#### ***Noncontrolling Interest for Sogou***

As Sohu is Sogou's controlling shareholder, Sogou's financial results have been consolidated with those of Sohu for all periods presented. To reflect the economic interest in Sogou held by shareholders other than Sohu (the noncontrolling shareholders), Sogou's net income/(loss) attributable to these noncontrolling shareholders is recorded as noncontrolling interest in the Sohu Group's consolidated statements of comprehensive income. Sogou's cumulative results of operations attributable to these noncontrolling shareholders, along with changes in shareholders' equity/(deficit) and adjustment for share-based compensation expense in relation to those share-based awards which are unvested and vested but not yet settled and noncontrolling shareholders' original investments in Series A Preferred Shares are accounted for as a noncontrolling interest classified as permanent equity in the Sohu Group's consolidated balance sheets, as redemption of the noncontrolling

## Edgar Filing: SOHU COM INC - Form 10-Q

interest is solely within the control of Sohu. These treatments are based on the terms governing investment by the noncontrolling shareholders in the Series A Preferred Shares of Sogou (the Sogou Series A Terms ) the terms of Sogou s restructuring, and Sohu s purchase of Sogou Series A Preferred Shares from Alibaba.

**Table of Contents**

By virtue of these terms, as Sogou has been losing money after its restructuring, the net losses have been and will be allocated in the following order:

- (i) net losses were allocated to ordinary shareholders until their basis in Sogou decreased to zero;
- (ii) additional net losses will be allocated to holders of Sogou Series A Preferred Shares until their basis in Sogou decreases to zero; and
- (iii) further net losses will be allocated between ordinary shareholders and holders of Sogou Series A Preferred Shares based on their shareholding percentage in Sogou.

Any subsequent net income from Sogou will be allocated in the following order:

- (i) net income will be allocated between ordinary shareholders and holders of Sogou Series A Preferred Shares based on their shareholding percentage in Sogou until their basis in Sogou increases to zero;
- (ii) additional net income will be allocated to holders of Sogou Series A Preferred Shares to bring their basis back;
- (iii) further net income will be allocated to ordinary shareholders to bring their basis back; and
- (iv) further net income will be allocated between ordinary shareholders and holders of Sogou Series A Preferred Shares based on their shareholding percentage in Sogou.

***Noncontrolling Interest in the Consolidated Balance Sheets***

As of June 30, 2013 and December 31, 2012, noncontrolling interest in the consolidated balance sheets was \$279.3 million and \$231.0 million, respectively.

	As of	
	June 30, 2013 (in thousands)	December 31, 2012 (in thousands)
Changyou	\$ 259,264	\$ 203,995
Sogou	18,049	24,645
Others	2,033	2,354
Total	\$ 279,346	\$ 230,994

***Noncontrolling Interest of Changyou***

As of June 30, 2013 and December 31, 2012, \$259.3 million and \$204.0 million, respectively, noncontrolling interest was recognized in the Sohu Group's consolidated balance sheets, representing a 33% and a 32%, respectively, economic interest in Changyou's net assets and reflected the reclassification of Changyou's share-based compensation expense from shareholders' additional paid-in capital to noncontrolling interest.

***Noncontrolling Interest of Sogou***

## Edgar Filing: SOHU COM INC - Form 10-Q

As of June 30, 2013 and December 31, 2012, \$18.0 million and \$24.6 million, respectively, noncontrolling interest was recognized in the Sohu Group's consolidated balance sheets, representing Sogou's cumulative results of operations attributable to shareholders other than Sohu, Sogou's share-based compensation expenses, along with these shareholders' investments in the Series A Preferred Shares issued by Sogou.

### *Noncontrolling Interest in the Consolidated Statements of Comprehensive Income*

For the three and six months ended June 30, 2013, net income attributable to the noncontrolling interest in the consolidated statements of comprehensive income was \$24.5 million and \$47.6 million, respectively, compared with \$19.9 million and \$36.5 million, respectively, for the three months and six months ended June 30, 2012.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Changyou	\$ 24,656	\$ 22,170	\$ 49,890	\$ 42,015
Sogou	(37)	(2,477)	(1,966)	(5,548)
Others	(114)	179	(353)	5
Total	\$ 24,505	\$ 19,872	\$ 47,571	\$ 36,472



**Table of Contents***Noncontrolling Interest of Changyou*

For the three months ended June 30, 2013 and 2012, \$24.7 million and \$22.2 million, respectively, in net income attributable to the noncontrolling interest was recognized in the Sohu Group's consolidated statements of comprehensive income, representing a 33% and a 32%, respectively, economic interest in Changyou attributable to shareholders other than Sohu.

*Noncontrolling Interest of Sogou*

For the three months ended June 30, 2013 and 2012, \$37,000 and \$2.5 million, respectively, in net loss attributable to the noncontrolling interest was recognized in the Sohu Group's consolidated statements of comprehensive income, representing Sogou's net loss attributable to shareholders other than Sohu.

**14. Net Income per Share**

Basic net income per share is computed using the weighted average number of common shares outstanding during the period. 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 comprise shares issuable upon the exercise or settlement of share-based awards using the treasury stock method. The dilutive effect of share-based awards with performance requirements is not considered before the performance targets are actually met. The computation of diluted net income per share does not assume conversion, exercise, or contingent issuance of securities that would have an anti-dilutive effect (i.e. an increase in earnings per share amounts or a decrease in loss per share amounts) on net income per share. Additionally, for purposes of calculating the numerator of diluted net income per share, the net income attributable to the Sohu Group is adjusted as follows:

- (1) Changyou's net income attributable to the Sohu Group is determined using the percentage that the weighted average number of Changyou shares held by Sohu represents of the weighted average number of Changyou ordinary shares and shares issuable upon the exercise or settlement of share-based awards under the treasury stock method, instead of by the percentage held by Sohu of the total economic interest in Changyou, which is used for the calculation of basic net income per share.

For the second quarter of 2013, the percentage used for the calculation of basic and dilutive net income per share was 67.2% and 67.1%, respectively. In the calculation of the Sohu Group's diluted net income per share, all of Changyou's existing unvested restricted share units, and vested restricted share units that have not yet been settled are treated as vested and settled by Changyou under the treasury stock method, causing the percentage of the weighted average number of shares held by Sohu in Changyou to decrease from 67.2% to 67.1%. As a result, Changyou's net income attributable to the Sohu Group on a diluted basis decreased accordingly. This impact is presented as incremental dilution from Changyou in the table below.

- (2) Sogou's net income/(loss) attributable to the Sohu Group is determined using the percentage that the weighted average number of Sogou shares held by Sohu represents of the weighted average number of Sogou ordinary shares and Series A Preferred Shares, shares issuable upon the conversion of convertible preferred shares under the if-converted method, and shares issuable upon the exercise or settlement of share-based awards under the treasury stock method, instead of by Sogou's net income/(loss) allocated to the Sohu Group by virtue of the Sogou Series A Terms, the terms of the restructuring and Sohu's purchase of Sogou Series A Preferred Shares from Alibaba, which is used for the calculation of basic net income per share.

In the calculation of the Sohu Group's basic net income per share, Sogou's net income/(loss) attributable to the Group is determined according to the Sogou Series A Terms, the terms of the restructuring and Sohu's purchase of Sogou Series A Preferred Shares from Alibaba. For the second quarter of 2013, in the calculation of the Sohu Group's diluted net income per share, assuming a dilutive effect, the percentage of 70% was calculated by treating convertible preferred shares issued by Sogou as having been converted at the beginning of the period and unvested share options with the performance targets achieved as well as vested but unexercised share options as having been exercised during the period. The dilutive effect of share-based awards with a performance requirement was not considered before the performance targets were actually met. The above difference is presented as incremental dilution from Sogou in the table below.



**Table of Contents**

The following table presents the calculation of the Sohu Group's basic and diluted net income per share (in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
<b>Numerator:</b>				
Net income attributable to Sohu.com Inc., basic	\$ 21,626	\$ 12,782	\$ 46,057	\$ 35,890
<b>Effect of dilutive securities:</b>				
Incremental dilution from Changyou	(101)	(484)	(426)	(1,435)
Incremental dilution from Sogou	(21)	(1,543)	(1,139)	(3,457)
Net income attributable to Sohu.com Inc., diluted	\$ 21,504	\$ 10,755	\$ 44,492	\$ 30,998
<b>Denominator:</b>				
Weighted average basic common shares outstanding	38,259	38,002	38,214	38,043
<b>Effect of dilutive securities:</b>				
Share options and restricted share units	233	345	247	373
Weighted average diluted common shares outstanding	38,492	38,347	38,461	38,416
Basic net income per share attributable to Sohu.com Inc.	\$ 0.57	\$ 0.34	\$ 1.21	\$ 0.95
Diluted net income per share attributable to Sohu.com Inc.	\$ 0.56	\$ 0.28	\$ 1.16	\$ 0.81

**15. Subsequent Events*****Related to Changyou***

On July 27, 2013, Changyou's Board of Directors authorized a share repurchase program of up to \$100 million of the outstanding ADSs of Changyou over a two-year period from July 27, 2013 to July 26, 2015. The ADSs may be purchased from time to time at management's discretion at prevailing market prices in the open market in accordance with Rule 10b-18 under the Securities Exchange Act of 1934. Changyou's management will determine the timing and amount of any purchases of Changyou's ADSs based on their evaluation of market conditions, the trading price of Changyou's ADSs and other factors. The purchase program may be suspended or discontinued at any time.

***Related to Sogou***

As of June 30, 2013, 23,424,750 share options granted under the Sogou 2010 Share Incentive Plan, and 8,978,500 share options granted under an arrangement approved by the Board of Directors of Sohu and Sogou in March 2011, will become vested and exercisable in four equal installments, with each installment vesting upon a service period requirement being met and Sogou's achievement of performance targets for the corresponding period. The performance target for each installment will be set at the beginning of each vesting period; therefore, for purposes of recognition of share-based compensation expense, each installment is considered to be granted at that date. As of June 30, 2013, performance targets were set for 12,960,400 of the 23,424,750 share options and 5,466,875 of the 8,978,500 share options. As a result, those options vesting upon service period requirements for management and key employees being met and Sogou's achievement of performance targets were considered granted. See Note 10 - Sohu.com Inc. Shareholders' Equity - Stock Incentive Plan.

On July 27, 2013, performance targets were set for another 2,908,125 of the 23,424,750 share options, and another 1,118,875 of the 8,978,500 share options. As a result, as of July 27, 2013, 15,868,525 of the 23,424,750 share options and 6,585,750 of the 8,978,500 share options were considered granted for the purposes of recognition of share-based compensation expense.

**16. Recently Issued Accounting Pronouncements**

None.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*As used in this report, references to us, we, our, our company, our Group, Sohu, the Sohu Group, and Sohu.com are to Sohu.com Inc. and, except where the context requires otherwise, our wholly-owned and majority-owned subsidiaries and variable interest entities ( VIEs ), Sohu.com Limited, Sohu.com (Hong Kong) Limited ( Sohu Hong Kong ), All Honest International Limited, Sohu.com (Game) Limited ( Sohu Game ), Go2Map Inc., Sohu.com (Search) Limited, Sogou Inc., Sogou (BVI) Limited, Sogou Hong Kong Limited, Vast Creation Advertising Media Services Limited ( Vast Creation ), Fox Video Investment Holding Limited ( Video Investment ), Fox Video Limited ( Sohu Video ), Fox Video (HK) Limited ( Video HK ), Beijing Sohu New Era Information Technology Co., Ltd. ( Sohu Era ), Beijing Sohu Software Technology Co., Ltd. ( New Software ), Beijing Fire Fox Digital Technology Co., Ltd. ( Beijing Fire Fox, also known as Beijing Huohu Digital Technology Co., Ltd., or Huohu ), Beijing Sohu Interactive Software Co., Ltd. ( Sohu Software ), Go2Map Software (Beijing) Co., Ltd. ( Go2Map Software ), Beijing Sogou Technology Development Co., Ltd. ( Sogou Technology ), Beijing Sogou Network Technology Co., Ltd. ( Sogou Network ), Fox Information Technology (Tianjin) Limited ( Video Tianjin ), Beijing Sohu New Media Information Technology Co., Ltd. ( Sohu Media ), Beijing Focus Time Advertising Media Co., Ltd. ( Focus Time ), Beijing Sohu New Momentum Information Technology Co., Ltd. ( Sohu New Momentum ), Beijing Century High Tech Investment Co., Ltd. ( High Century ), Beijing Sohu Entertainment Culture Media Co., Ltd. ( Sohu Entertainment, formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd., or Hengda ), Beijing Sohu Internet Information Service Co., Ltd. ( Sohu Internet ), Beijing GoodFeel Information Technology Co., Ltd. ( GoodFeel ), Beijing Sogou Information Service Co., Ltd. ( Sogou Information ), Beijing 21 East Culture Development Co., Ltd. ( 21 East Beijing ), Beijing Sohu Donglin Advertising Co., Ltd. ( Donglin ), Beijing Pilot New Era Advertising Co., Ltd. ( Pilot New Era ), Beijing Focus Yiju Network Information Technology Co., Ltd. ( Focus Yiju ), Beijing Yi He Jia Xun Information Technology Co., Ltd. ( Yi He Jia Xun ), Beijing Zhi Hui You Information Technology Co., Ltd. ( Zhi Hui You ), Tianjin Jinhui Culture Development Co., Ltd. ( Tianjin Jinhui ) and our independently-listed majority-owned subsidiary Changyou.com Limited ( Changyou, formerly known as TL Age Limited) as well as the following direct and indirect subsidiaries and VIEs of Changyou: Changyou.com HK Limited ( Changyou HK, formerly known as TL Age Hong Kong Limited), Changyou.com Webgames (HK) Limited ( Changyou HK Webgames ), Changyou.com Gamepower (HK) Limited ( Changyou HK Gamepower ), ICE Entertainment (HK) Limited ( ICE HK ), Changyou.com (US) Inc. (formerly known as AmazGame Entertainment (US) Inc.), Changyou.com (UK) Company Limited ( Changyou UK ), ChangyouMy Sdn. Bhd ( Changyou Malaysia ), Changyou.com Korea Limited ( Changyou Korea ), Changyou.com India Private Limited ( Changyou India ), Changyou BİLİŞİM HİZMETLERİ TİCARET LİMİTED ŞİRKETİ ( Changyou Turkey ), Kylie Enterprises Limited, 7Road.com Limited ( 7Road ), 7Road.com HK Limited ( 7Road HK ), Beijing AmazGame Age Internet Technology Co., Ltd. ( AmazGame ), Beijing Changyou Gamespace Software Technology Co., Ltd. ( Gamespace ), ICE Information Technology (Shanghai) Co., Ltd. ( ICE Information ), Beijing Yang Fan Jing He Information Consulting Co., Ltd. ( Yang Fan Jing He ), Shanghai Jingmao Culture Communication Co., Ltd. ( Shanghai Jingmao ), Shanghai Hejin Data Consulting Co., Ltd. ( Shanghai Hejin ), Beijing Changyou Jingmao Film & Culture Communication Co., Ltd. ( Beijing Jingmao ), Beijing Gamease Age Digital Technology Co., Ltd. ( Gamease ), Beijing Guanyou Gamespace Digital Technology Co., Ltd. ( Guanyou Gamespace ), and Shanghai ICE Information Technology Co., Ltd. ( Shanghai ICE ), Shenzhen 7Road Network Technologies Co., Ltd. ( 7Road Technology ), Shenzhen 7Road Technology Co., Ltd. ( Shenzhen 7Road ), and these references should be interpreted accordingly. Unless otherwise specified, references to China or PRC refer to the People's Republic of China and do not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words expect, anticipate, intend, believe, or similar language. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our business and financial performance are subject to substantial risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information set forth under the heading Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission ( SEC ) on February 28, 2013, as updated by Part II Item 1A of this report. Readers are cautioned not to place undue reliance on these forward-looking statements.*

**OVERVIEW**

Sohu (NASDAQ: SOHU) is a leading Chinese online media, search, gaming, community and mobile service group. We operate one of the most comprehensive matrices of Chinese language content and services, and we developed and operate one of the most popular massively multiplayer online games and two popular Web games in China. Substantially all of our operations are conducted through our indirect wholly-owned and majority-owned China-based subsidiaries and variable interest entities (collectively the Sohu Group or the Group).

---

## **Table of Contents**

Our businesses consist of the online advertising business, which consists of the brand advertising business as well as the search and others business, the online game business, the mobile business and the others business, of which online advertising and online games are our core businesses.

### **Factors and Trends Affecting our Business**

The Internet and Internet-related markets in China continued to evolve rapidly during the first half of 2013. According to a semiannual report issued by the China Internet Network Information Center ( CNNIC ), the total number of Internet users in China had reached 591 million by June 30, 2013, an increase of 26.6 million from the end of 2012. The CNNIC also reported that the number of mobile Internet users in China had reached 464 million by June 30, 2013, an increase of 43.8 million from the end of 2012, exceeding the 411 million desktop computer Internet users as of June 30, 2013, which is an indication that mobile Internet is becoming the top channel for Internet users to consume online content in China. We believe that this large and expanding user base will continue to provide significant opportunities to expand our product offerings and to explore new revenue streams.

In China, online video is a top Internet application, with over 389 million users as of June 30, 2013, according to CNNIC. We expect that brand advertisers will continue to allocate more advertising dollars to online video in order to exploit this growing market. To better employ market opportunities, we set up a dedicated advertising sales force for our online video business in 2012. We expect growth in video advertising revenue to accelerate in 2013.

Our search and others business continued to grow, which was attributable to the growth of pay-for-click services, as well as online marketing services on the Sogou Web Directory. We expect our search and others business to sustain healthy revenue growth through the remainder of 2013.

Our strong performance of online game business in the second quarter reflects the growth of the China online game industry. We also believe that it reflects the ongoing strength of our online games content as we are constantly updating our games based on user feedback, which helps to extend the popularity of our games in China. We also have made a successful transition from a pure-play game developer to a broad spectrum gaming company offering multiple types of games on different devices and owning the leading game information portal, 17173.com, in China. On May 1, 2013, Changyou entered into an agreement to acquire all of the ordinary shares of 7Road.com Limited ( 7Road ) held by the noncontrolling shareholders, representing 28.074% of the outstanding share capital of 7Road, for aggregate fixed cash consideration of approximately \$78 million. Following the closing of the acquisition on June 5, 2013, 7Road became an indirect wholly-owned subsidiary of Changyou, and Changyou's VIE Gamease became the sole shareholder of 7Road's VIE Shenzhen 7Road Technology Co., Ltd ( Shenzhen 7Road ).

### **Summary of Our Business**

#### ***Online Advertising Business***

##### *Brand Advertising Business*

Our brand advertising business offers to our users, over our matrices of Chinese language Web content and services, various products and services (such as free of charge content, including news, video, interactive community, and other competitive Internet services) across multiple internet-enabled devices, such as PCs, mobile phones and tablets.

The majority of our products and services are provided on the following platforms:

Sohu.com, a leading mass portal and media destination;

Focus.cn, a top real estate Website; and

17173.com, a leading game information portal. Since December 15, 2011, 17173.com has been owned and operated by our majority-owned subsidiary Changyou.com Limited ( Changyou ).

##### *Search and Others Business*

## Edgar Filing: SOHU COM INC - Form 10-Q

Our search and others business, provided by our search subsidiary Sogou Inc. ( Sogou ), primarily offers customers pay-for-click services, as well as online marketing services on the Sogou Web Directory. Pay-for-click services enable our advertisers promotional links to be displayed on Sogou search result pages and Sogou Website Alliance members Websites where the links are relevant to the subject and content of such Web pages. Both pay-for-click services and online marketing services on the Sogou Web Directory expand distribution of our advertisers Website links or advertisements by leveraging traffic on Sogou Website Alliance members Websites.

---

## **Table of Contents**

### ***Online Game Business***

Our online game business is conducted via Changyou, a leading online game developer and operator in China. Changyou engages in the development, operation and licensing of online games, including massively multiplayer online games (MMOGs), Web games and mobile games. Changyou developed and operates Tian Long Ba Bu (TLBB), which is one of the most popular MMOGs in China, and developed, and primarily jointly operates with third-party joint operators, DDTank and Wartune (also known as Shen Qu), which are two popular Web games in China. For the second quarter of 2013, more than 70% of the revenues of Changyou's online game business were derived from TLBB.

We depend on Changyou for a significant portion of our revenues, net income, and operating cash flow. For the second quarter of 2013, Changyou's online game revenues were \$168.3 million, which represented 50% of our total revenues. Net income contributed by Changyou for the quarter was \$82.3 million, which represented 155% of our total net income.

### ***Mobile Business***

Our mobile business offers mobile related services through different types of mobile products to mobile phone users. The mobile products mainly consist of short messaging services (SMS), mobile games, Ring Back Tone (RBT), mobile video and interactive voice response (IVR). A majority of the content is purchased from third party content providers.

### ***Others Business***

Our others business are primarily generated from our business of offering Internet value-added services (IVAS) with respect to Web games developed by third-party developers under revenue-sharing arrangements with the developers, offering cinema advertisement slots to be shown in theaters before the screening of movies, and sub-licensing of licensed video content to third parties.

## **Business Restructuring**

### ***7Road Transactions***

On May 11, 2011, Changyou, through its VIE Gamease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road's financial statements on June 1, 2011. Effective June 26, 2012, Shenzhen 7Road was reorganized into a Cayman Islands holding company structure where Changyou holds a direct ownership interest in 7Road through Changyou's subsidiary Changyou.com Webgames (HK) Limited, and Shenzhen 7Road is a VIE of 7Road. On June 21, 2012, Mr. Kai Cao, who was then 7Road's Chief Executive Officer, surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the then outstanding share capital of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou's interest in 7Road increased to 71.926%. When 7Road and Shenzhen 7Road are discussed in this report, the reorganization is treated as if it had been effective upon Changyou's initial acquisition of the equity interests of Shenzhen 7Road.

On May 1, 2013, Changyou entered into an agreement to acquire all of the ordinary shares of 7Road held by the noncontrolling shareholders, representing 28.074% of the outstanding share capital of 7Road, for aggregate cash consideration of approximately \$78 million. Effective with Changyou's entering into the acquisition agreement, Mr. Dewen Chen, Changyou's President, was appointed as the Chairman and acting Chief Executive Officer of 7Road, and Mr. Kai Cao resigned as a director and as Chief Executive Officer of 7Road.

The acquisition closed on June 5, 2013. Effective with the closing, 7Road became an indirect wholly-owned subsidiary of Changyou, and Changyou's VIE Gamease became the sole shareholder of 7Road's VIE Shenzhen 7Road. Also effective upon the closing, the former noncontrolling shareholders' existing non-compete covenants with Changyou were terminated, and an agreement took effect under which the former noncontrolling shareholders agreed, for a period of two years after the closing, to not solicit or hire existing employees of 7Road.

As of June 30, 2013, Changyou had paid \$76 million of the total cash consideration. The remaining \$2 million will be settled in June 2014.

### ***17173 Transaction***

On December 15, 2011, Sohu closed the sale to Changyou of certain assets associated with the business of 17173.com (the 17173 Business) for fixed cash consideration of \$162.5 million. After the closing of the sale, Sohu continued to consolidate the results of operations of the 17173 Business in our consolidated financial statements.



*Sogou Transactions*

On October 22, 2010, Sogou sold 24.0 million, 14.4 million and 38.4 million, respectively, of its newly-issued Series A Preferred Shares to Alibaba Investment Limited ( Alibaba ), a private investment subsidiary of Alibaba Group Holding Limited, China Web Search (HK) Limited ( China Web ), an investment vehicle of Yunfeng Fund, LP, and Photon Group Limited ( Photon ), the investment fund of Sohu's Chairman and Chief Executive Officer Dr. Charles Zhang, for \$15 million, \$9 million, and \$24 million, respectively. On June 29, 2012, Sohu purchased the 24.0 million Sogou Series A Preferred Shares held by Alibaba for fixed cash consideration of \$25.8 million.

---

## **Table of Contents**

As of June 30, 2013, Sohu held 70% of the combined total of Sogou's outstanding ordinary shares and Series A Preferred Shares. As Sohu is Sogou's controlling shareholder, we continue to consolidate Sogou in our consolidated financial statements, but recognize noncontrolling interest reflecting economic interest held by shareholders other than Sohu.

### ***Changyou Transactions***

On April 7, 2009, Changyou completed an initial public offering of its ADSs on the NASDAQ Global Select Market under the symbol CYOU. Each of Changyou's ADS represents two ordinary shares.

As of June 30, 2013, Sohu held approximately 67% of the combined total of Changyou's outstanding ordinary shares and controlled approximately 81% of the total voting power in Changyou. As Sohu is Changyou's controlling shareholder, we continue to consolidate Changyou in our consolidated financial statements, but recognize noncontrolling interest reflecting the economic interest in Changyou held by shareholders other than Sohu.

## **CRITICAL ACCOUNTING POLICIES AND MANAGEMENT ESTIMATES**

Our discussion and analysis of our financial condition and results of operations relates to our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, costs and expenses, and related disclosures. On an on-going basis, we evaluate our estimates based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Identified below are the accounting policies that reflect our more significant estimates and judgments, and those that we believe are the most critical to fully understanding and evaluating our consolidated financial statements.

### **Basis of Consolidation**

Our consolidated financial statements include the accounts of Sohu.com Inc. and its direct and indirect wholly-owned and majority-owned subsidiaries and consolidated variable interest entities ( VIEs ). All intercompany transactions are eliminated.

### ***VIE Consolidation***

Our Group adopted the guidance of accounting for VIEs, which requires VIEs to be consolidated by the primary beneficiary of the entity. For the consolidated VIEs, management made evaluations of the relationships between us and our VIEs and the economic benefit flow of contractual arrangements with the VIEs. In connection with such evaluation, management also took into account the fact that, as a result of such contractual arrangements, we control the shareholders' voting interests in these VIEs. As a result of such evaluation, management concluded that we are the primary beneficiary of our consolidated VIEs. Our Group has one VIE that is not consolidated, since we are not the primary beneficiary.

### ***Noncontrolling Interest Recognition***

Noncontrolling interests are recognized to reflect the portion of the equity of majority-owned subsidiaries and VIEs which is not attributable, directly or indirectly, to the controlling shareholder. Currently, the noncontrolling interests in our consolidated financial statements primarily consist of noncontrolling interests for Changyou and Sogou.

### ***Noncontrolling Interest for Changyou***

To reflect the economic interest in Changyou held by shareholders other than Sohu ( noncontrolling shareholders ), Changyou's net income attributable to these noncontrolling shareholders is recorded as noncontrolling interest in Sohu's consolidated statements of comprehensive income, based on their share of the economic interests in Changyou. Changyou's cumulative results of operations attributable to these noncontrolling shareholders, along with changes in shareholders' equity, adjustment for share-based compensation expense in relation to those share-based awards which are unvested and vested but not yet settled and adjustment for changes in Sohu's ownership in Changyou, are recorded as noncontrolling interest in our consolidated balance sheets.



---

## **Table of Contents**

### *Noncontrolling Interest for Sogou*

To reflect the economic interest in Sogou held by shareholders other than Sohu ( noncontrolling shareholders ), Sogou's net income /loss attributable to these noncontrolling shareholders is recorded as noncontrolling interest in Sohu's consolidated statements of comprehensive income. Sogou's cumulative results of operations attributable to these noncontrolling shareholders, along with changes in shareholders' equity / (deficit) and adjustment for share-based compensation expense in relation to those share-based awards which are unvested and vested but not yet settled and noncontrolling shareholders' investments in Series A Preferred Shares are accounted for as a noncontrolling interest classified as permanent equity in our consolidated balance sheets, as redemption of the noncontrolling interest is solely within our control. These treatments are based on the terms governing investment by the noncontrolling shareholders in the Series A Preferred Shares of Sogou (the Sogou Series A Terms ), the terms of Sogou's restructuring, and Sohu's purchase of Sogou Series A Preferred Shares from Alibaba. By virtue of these terms, as Sogou has been losing money since its restructuring, the net losses have been and will be allocated in the following order:

- (i) net losses were allocated to ordinary shareholders until their basis in Sogou decreased to zero;
- (ii) additional net losses will be allocated to holders of Sogou Series A Preferred Shares until their basis in Sogou decreases to zero; and
- (iii) further net losses will be allocated between ordinary shareholders and holders of Sogou Series A Preferred Shares based on their shareholding percentage in Sogou.

Any subsequent net income from Sogou will be allocated in the following order:

- (i) net income will be allocated between ordinary shareholders and holders of Sogou Series A Preferred Shares based on their shareholding percentage in Sogou until their basis in Sogou increases to zero;
- (ii) additional net income will be allocated to holders of Sogou Series A Preferred Shares to bring their basis back;
- (iii) further net income will be allocated to ordinary shareholders to bring their basis back; and
- (iv) further net income will be allocated between ordinary shareholders and holders of Sogou Series A Preferred Shares based on their shareholding percentage in Sogou.

### ***Segment Reporting***

Our Group's segments are business units that offer different services and are reviewed separately by the chief operating decision maker ( CODM ), or the decision making group, in deciding how to allocate resources and in assessing performance. Our Group's CODM is Sohu.com Inc.'s Chief Executive Officer. There are five segments in our Group, consisting of brand advertising, Sogou (which mainly consists of the search and others business), Changyou (which mainly consists of the online game business), mobile and others.

### **Revenue Recognition**

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. The recognition of revenues involves certain management judgments. The amount and timing of our revenues could be materially different for any period if management made different judgments or utilized different estimates.

Under ASC 845, barter trade transactions in which physical goods or services (other than advertising services) are received in exchange for advertising services should be recorded based on the fair values of the goods and/or services received. For our online advertising-for-online advertising barter transactions, no revenue or expense is recognized because the fair value of neither the advertising surrendered nor the advertising received is determinable.

### ***Online Advertising Revenues***

Online advertising revenues include revenues from brand advertising services as well as search and others services.

We recognize gross revenue for the amount of fees we receive from our advertisers. Determining whether revenue should be reported gross or net is based on an assessment of various factors. The primary factor is whether we are acting as the principal in offering services to the customer

## Edgar Filing: SOHU COM INC - Form 10-Q

or whether we are acting as an agent in the transaction. Whether we are serving as principal or agent in a transaction is judgmental in nature and is determined by evaluating the terms of the arrangement. Our revenues from online advertising services are recognized on a gross basis as we have the primary responsibility for fulfillment and acceptability. These revenues are recognized after deducting agent rebates paid to advertising agencies and applicable taxes and /or related surcharges.

Before September 1, 2012, our online advertising revenues were subject to PRC business tax ( Business Tax ). Business Tax is imposed primarily on revenues from the provision of taxable services and is calculated by multiplying the applicable tax rate by gross revenue. Our online advertising revenues were recognized after deducting agent rebates and applicable Business Tax and related surcharges. Effective September 1, 2012, the PRC Ministry of Finance and the State Administration of Taxation launched a Business Tax to Value Added Tax ( VAT ) Transformation Pilot Program ( Pilot Program ) for certain industries in eight regions, including Beijing and Tianjin.

---

## **Table of Contents**

On May 24, 2013, it was announced that commencing August 1, 2013 the Pilot Program will be expanded to all regions in PRC. VAT payable on goods sold or taxable labor services provided by a general VAT taxpayer for a taxable period is the net balance of the output VAT for the period after crediting the balance of VAT input. Hence, the amount of VAT payable does not result directly from output VAT generated from goods sold or taxable labor services provided. With the adoption of the Pilot Program, our online advertising revenues are subject to VAT. Our online advertising revenues are now recognized after deducting agent rebates and net of VAT and related surcharges.

### *Brand Advertising Revenues*

#### Business Model

Currently the brand advertising business has two main types of pricing models, consisting of the Fixed Price Model and the Cost Per Impression ( CPM ) pricing model. Under the Fixed Price Model, a contract is signed to establish a fixed price for the advertising services to be provided. Under the CPM pricing model, the total contract amount for the advertising services is not fixed, but the unit price for each qualifying display is fixed. A qualifying display is defined as the appearance of an advertisement, where the advertisement meets criteria specified in the contract with the advertiser. Advertising fees are charged to the advertisers based on the unit prices and the number of qualifying displays. We provide advertisement placements to our advertisers on different Website channels and in different formats, which include, among other things, banners, links, logos, buttons, full screen, pre-roll, post-roll, and mid-roll video screens, as well as pause video screens.

#### Revenue Recognition

For brand advertising revenue recognition, prior to entering into contracts, we make a credit assessment of the customer. For contracts for which collectability is determined to be reasonably assured, we recognize revenue when all revenue recognition criteria are met. Otherwise, we only recognize revenue when the cash is received and all other revenue recognition criteria are met.

Before 2011, since almost all of the elements were delivered within one calendar quarter, we treated all elements of advertising contracts as one single unit of accounting for revenue recognition purposes. Commencing January 1, 2011, in accordance with *ASU No.2009-13*, we treat advertising contracts with multiple deliverable elements as separate units of accounting for revenue recognition purposes and to recognize revenue on a periodic basis during the contract when each deliverable service is provided. Since the contract price is for all deliverables, we allocate the arrangement consideration to all deliverables at the inception of the arrangement on the basis of their relative selling prices. Since the number of advertising contracts that covered more than one quarter and the revenues from advertising contracts that covered more than one quarter were immaterial compared to the total advertising contracts, the impact of adoption of *ASU No.2009-13* to us is immaterial.

### *Search and Others Revenues*

Search and others services mainly include pay-for-click services, as well as online marketing services on the Sogou Web Directory.

#### Pay-for-click Services

Pay-for-click services are services that enable our advertisers promotional links to be displayed on Sogou search result pages and Sogou Website Alliance members Websites where the links are relevant to the subject and content of such Web pages. For pay-for-click services, we introduce Internet users to our advertisers through our auction based pay-for-click systems and charge advertisers on a per click basis when the users click on the displayed links. Revenue for pay-for-click services is recognized on a per click basis when the users click on the displayed links.

#### Online Marketing Services on the Sogou Web Directory

Online marketing services on the Sogou Web Directory mainly consist of displaying advertiser Website links on the Web pages of the Sogou Web Directory. The Sogou Web Directory is a Chinese Web directory navigation site which serves as a key access point to popular and preferred Websites and applications. Revenue for online marketing services on the Sogou Web Directory is normally recognized on a straight-line basis over the contract period, provided our obligations under the contract have been met and all revenue recognition criteria have been met.

#### Sogou Website Alliance

Both pay-for-click services and online marketing services on the Sogou Web Directory expand distribution of advertisers Website links or advertisements by leveraging traffic on Sogou Website Alliance members Websites. We recognize gross revenue for the amount of fees we

## Edgar Filing: SOHU COM INC - Form 10-Q

receive from advertisers. Payments made to Sogou Website Alliance members are included in cost of search and others revenues as traffic acquisition costs.

---

**Table of Contents**

Determining whether revenue should be reported gross or net is based on an assessment of various factors. The primary factor is whether we are acting as the principal in offering services to the customer or we are acting as an agent in the transaction. For pay-for-click services we recognize gross revenue, as we have the primary responsibility for fulfillment and acceptability. Whether we are serving as principal or agent in a transaction is judgmental in nature and is determined by evaluating the terms of the arrangement. We pay Sogou Website Alliance members based on either revenue-sharing arrangements, under which we pay a percentage of pay-for-click revenues generated from clicks by users of their properties, or on a pre-agreed unit price.

***Online Game Revenues***

Our online game revenues are generated from MMOG operations revenues, Web game revenues and overseas licensing revenues.

***MMOG operations revenues***

Revenues are recorded net of applicable Business Tax, discounts and rebates to distributors.

Online game revenues from Changyou's current MMOG operations are earned by providing online services to players pursuant to the item-based revenue model. Under the item-based revenue model, the basic game play functions are free of charge and players are charged for purchases of in-game virtual items. Online game revenues are recognized over the estimated lives of the virtual items purchased or as the virtual items are consumed. If different assumptions were used in deriving the estimated lives of the virtual items, the timing of our recording of the revenues would be impacted.

Game operations revenues are collected by Changyou's VIEs through the sale of Changyou's prepaid cards, which it sells in both virtual and physical forms to third-party distributors and players. Proceeds received from sales of prepaid cards are initially recorded as receipts in advance from customers and, upon activation or charge of the prepaid cards, are transferred from receipts in advance from customers to deferred revenues. As Changyou does not have control of, and generally does not know, the ultimate selling price of the prepaid cards sold by distributors, net proceeds from distributors form the basis of revenue recognition. Prepaid cards will expire two years after the date of card production if they have never been activated. The proceeds from the expired game cards are recognized as revenue upon expiration of cards. Once the prepaid cards are activated and credited to a player's personal game account, they will not expire as long as the personal game account remains active. Changyou is entitled to suspend and close a player's personal game account if it has been inactive for a period of 180 consecutive days. The unused balances in an inactive player's personal game account are recognized as revenues when the account is suspended and closed.

***Web game revenue***

Changyou began generating Web game revenue after its acquisition of a controlling interest in 7Road in May 2011. Through December 31, 2011, 7Road's revenues were derived entirely from revenue-sharing payments from third-party joint operators of its games and license fees from certain of these joint operators. Beginning in the year ended December 31, 2012, 7Road also derives revenues from direct operation of Wartune on its own Website for the game, which was launched in May 2012. The games developed by 7Road are operated primarily under the item-based revenue model, in which game players can access the games free of charge, but may purchase consumable virtual items, including those with a predetermined expiration time, or perpetual virtual items, such as certain costumes that stay bound to a game player throughout the life of the game. In certain of its joint operation arrangements, 7Road provides its games and related services to a third-party joint operator at no upfront fee. In these arrangements, 7Road is entitled to a single stream of revenue-sharing payments from the joint operator when game players convert the joint operator's virtual currency into 7Road's game coins or purchase its game coins directly through such operator's Websites or game platform. Certain of the joint operators pay 7Road license fees for the exclusive right to operate its games in specified geographic areas or upon achievement of certain performance milestones from the joint operators' operation of the games. Certain of the joint operators also pay 7Road license fees for the right to be among a selected few who will have the initial right ahead of other operators to jointly operate 7Road's games in China during a specified period after their launch.

When 7Road's games are jointly operated through the Websites or platforms of third-party joint operators, the games may be hosted either on the third-party operators' servers or on servers that 7Road owns or leases from Internet data centers. In its arrangements with third-party joint operators, 7Road views the third-party joint operators as its customers and does not view 7Road as the primary obligor, as it does not have the primary responsibility for fulfillment and acceptability of the game services. For 7Road's direct operation of its Web game Wartune through its Website for the game, 7Road is obligated to provide on-going services to the game players, and such obligation is not deemed to be inconsequential and perfunctory after game players purchase its game coins directly through its Website for Wartune. Therefore, 7Road's revenues from direct operation of Wartune on its Website for the game are first recorded by 7Road as deferred revenues and subsequently recognized as revenue over the service period during which 7Road is obligated to provide services to the game players to enable them to consume their virtual items.





## **Table of Contents**

PRC tax authorities have determined that all of 7Road's game revenues from the joint operation of its games within China, which are generated through Shenzhen 7Road, are subject to 17% PRC VAT, and that Shenzhen 7Road, as a Software Enterprise, is entitled to a 14% VAT refund immediately upon the filing of its VAT returns, with the result that 7Road's net effective PRC VAT rate is 3%. 7Road presents PRC VAT on a gross basis, by which VAT at the rate of 17% is included in revenues, and 7Road's net effective PRC VAT rate of 3% is included in cost of revenues, because Shenzhen 7Road's 17% VAT obligation and its entitlement to a 14% VAT refund are one integrated preferential VAT policy.

### *Overseas licensing revenue*

Changyou enters into licensing arrangements with overseas licensees to operate its MMOGs in other countries or regions. These license agreements provide two revenue streams, consisting of an initial license fee and a monthly revenue-based royalty fee based on monthly revenue and sales from ancillary products of the games. The initial license fee is based on both a fixed amount and additional amounts receivable upon the games achieving certain sales targets. Since Changyou is obligated to provide post-sales services such as technical support and provision of updates and when-and-if-available upgrades to the licensees during the license period, the initial license fee from the licensing arrangement is recognized as revenue ratably over the license period. The fixed amount of the initial license fee is recognized ratably over the remaining license period from the launch of the game and the additional amount is recognized ratably over the remaining license period from the date when such additional amount is certain. The monthly revenue-based royalty fee is recognized when relevant services are delivered, provided that collectability is reasonably assured.

### *Mobile Revenues*

Our mobile revenues are generated from the provision of mobile-related services through different types of mobile products to mobile phone users. The mobile products mainly consist of SMS, mobile games, RBT, mobile video and IVR. In order to deliver our products to mobile phone users, we sign contracts with China Mobile Communications Corporation, China United Network Communication Group Company Limited, China Telecom Corporation and their subsidiaries and other small mobile network operators (collectively, the China mobile network operators). We obtain fees from the China mobile network operators, which charge users on a monthly or per message/download basis for mobile services we provide. After the receipt of service fees from China mobile network operators, we make payments to third party mobile service alliance and content providers based on revenue-sharing arrangements.

Mobile revenues are recognized on gross or net basis, determined by evaluating the terms of the arrangement to determine whether we are serving as principal or agent in a transaction. To determine the amount of revenues to be recognized in the month in which the service is performed, provided that no significant obligations remain, we rely on billing confirmations issued by the China mobile network operators. If at the end of each reporting period, an operator has not yet issued such billing confirmations, we estimate the amount of collectable mobile service fees and recognize revenue. When we later receive billing confirmations, we record a true-up accounting adjustment. For the three months ended June 30, 2013, 68% of our estimated mobile revenues were confirmed by billing confirmations received from the China mobile network operators. Generally, (i) within 15 to 120 days after the end of each month, we receive billing confirmations from the operators and (ii) within 30 to 180 days after delivering billing confirmations, each operator remits the mobile service fees, net of its service fees, to us.

### *Others Revenues*

Others revenues are primarily generated from our business of offering IVAS with respect to Web games developed by third-party developers under revenue-sharing arrangements with the developers, offering cinema advertisement slots to be shown in theaters before the screening of movies, and sub-licensing of licensed video content to third parties.

### *Revenues from IVAS*

We offer Web games developed by third-party developers and generate revenues from the provision of IVAS, including promotion, access maintenance and payment services, to third-party developers. Under revenue-sharing agreements that we sign with third-party developers, we collect payments from the end users, keep a pre-agreed percentage of the proceeds and remit the balance to the third-party developers. Revenues from IVAS are recognized when our obligations under the agreements and all other revenue recognition criteria have been met.

### *Revenues from cinema advertisements*

For cinema advertising services, a contract is signed with the advertiser to establish a fixed price and specify the advertising services to be provided. Pursuant to the contracts, we provide advertisement placements in advertising slots to be shown in theatres before the screening of movies. When all the recognition criteria are met, revenues from cinema advertising are recognized under either the proportional performance method or the straight-line method, depending on the terms of the customer contract. Under the proportional performance method, revenues are

## Edgar Filing: SOHU COM INC - Form 10-Q

generally recognized based on a percentage of the advertising slots actually delivered. Under the straight-line method, revenues are recognized on a straight-line basis over the contract period.

---

## **Table of Contents**

### *Revenues from sub-licensing of licensed video content*

For licensed video content purchased on an exclusive basis, we have rights to sub-license to other platforms. Revenues from sub-licensing of licensed video content are recognized when the content is available for immediate and unconditional delivery under an existing sub-licensing arrangement, the sub-license period has begun and the sub-licensing fee is fixed or determinable and collection of the sub-licensing fee is reasonably assured.

### **Share-based Compensation Expense**

Sohu, Changyou, Sogou, Sohu Video and 7Road all have incentive plans for the granting of share-based awards, including common stock /ordinary shares, share options, restricted shares and restricted share units, to their executive officers, management and employees.

Share-based compensation expense is recognized as costs and /or expenses in the consolidated statements of comprehensive income based on the fair value of the related share-based awards on their grant dates. Share-based compensation expense is charged to the shareholders' equity or noncontrolling interest section in the consolidated balance sheets. The assumptions used in share-based compensation expense recognition represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. If factors change or different assumptions are used, our share-based compensation expense could be materially different for any period. Moreover, the estimates of fair value are not intended to predict actual future events or the value that ultimately will be realized by employees who receive equity awards, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by us for accounting purposes.

### *Sohu, Changyou, and Sogou share-based awards*

For Sohu share-based awards, in determining the fair value of share options granted, the Black-Scholes valuation model is applied; in determining the fair value of restricted share units granted, the public market price of the underlying shares on the grant dates is applied.

For Changyou share-based awards, in determining the fair value of ordinary shares, restricted shares and restricted share units granted in 2008, the income approach /discounted cash flow method with a discount for lack of marketability was applied, given that the shares underlying the awards were not publicly traded at the time of grant. In determining the fair value of restricted share units granted in 2009 before Changyou's initial public offering, the fair value of the underlying shares was determined based on Changyou's offering price for its initial public offering. In determining the fair value of restricted share units granted after Changyou's initial public offering, the public market price of the underlying shares on the grant dates is applied.

For Sogou share-based awards, in determining the fair value of share options granted, the income approach /discounted cash flow method with a discount for lack of marketability was applied, given that the shares underlying the awards were not publicly traded at the time of grant.

Share-based compensation expense for the ordinary shares granted is fully recognized in the quarter during which these ordinary shares are granted. For share options, restricted shares and restricted share units granted with respect to Sohu shares and with respect to Changyou shares, compensation expense is recognized on an accelerated basis over the requisite service period. For share options granted with respect to Sogou shares, compensation expense is recognized on a straight-line basis over the estimated period during which the service period requirement and performance target will be met. The number of share-based awards for which the service is not expected to be rendered over the requisite period is estimated, and the related compensation expense is not recorded for that number of awards.

### *Sohu Video share-based awards*

On January 4, 2012, Sohu Video, the holding entity of Sohu's video division, adopted a 2011 Share Incentive Plan (the "Video 2011 Share Incentive Plan") which provides for the issuance of up to 25,000,000 ordinary shares of Sohu Video (amounting to 10% of the outstanding Sohu Video shares on a fully-diluted basis) to management and key employees of the video division and to Sohu management. As of June 30, 2013, grants of options for the purchase of 15,352,200 of ordinary shares of Sohu Video had been made and were effective under the Video 2011 Share Incentive Plan.

For purposes of ASC 718, no grant date may be established until mutual understanding of the option awards' key terms and conditions between Sohu Video and the recipients can be reached, and such mutual understanding cannot be reached until the enterprise value of Sohu Video and hence the fair value of the options is determinable and can be accounted for.



## **Table of Contents**

Management concluded that as of June 30, 2013 certain significant factors necessary to determine the fair value of Sohu's video division remained uncertain. On the basis that the broader terms and conditions of the option awards had neither been finalized nor mutually agreed with the recipients, no grant of options occurred for purposes of ASC 718 and hence no share-based compensation expense was recognized for the three months ended June 30, 2013.

### ***7Road share-based awards***

On July 10, 2012, 7Road adopted a 2012 Share Incentive Plan (the "7Road 2012 Share Incentive Plan"), which initially provided for the issuance to selected directors, officers, employees, consultants and advisors of 7Road of up to 5,100,000 ordinary shares of 7Road (amounting to 5.1% of the then outstanding 7Road shares on a fully-diluted basis). On November 2, 2012, 7Road's Board of Directors and its shareholders approved an increase from 5,100,000 to 15,100,000 ordinary shares (amounting to 13.7% of the then outstanding 7Road shares on a fully-diluted basis) under the 7Road 2012 Share Incentive Plan.

On May 1, 2013, Changyou entered into an agreement to acquire all of the outstanding ordinary shares of 7Road held by the noncontrolling shareholders, representing 28.074% of the outstanding share capital of 7Road. The acquisition closed on June 5, 2013.

On June 28, 2013, 7Road's Board of Directors approved the cancellation of the 7Road 2012 Share Incentive Plan. 7Road concurrently offered to a total of 42 7Road employees holding an aggregate of 2,223,750 restricted share units which had been granted under the 7Road 2012 Share Incentive Plan the right to exchange their restricted share units for, at each employee's election, in each case subject to the employee's continued employment by 7Road, either (i) the right to a cash payment of up to an aggregate of \$2.90 per restricted share unit exchanged, vesting and payable at the rate of 40%, 30% and 30%, respectively, on the first, second and third anniversaries of July 18, 2012, which is the date when the surrendered restricted share units were granted under the 7Road 2012 Share Incentive Plan, or (ii) the right to receive an annual cash bonus, over a seven-year period commencing July 1, 2013, based on adjusted annual cumulative net income of 7Road. All restricted share units held by these 42 holders under the 7Road 2012 Share Incentive Plan as of June 28, 2013 were included in this exchange program.

As the original awards of restricted share units made under the 7Road 2012 Share Incentive Plan included as a vesting condition the completion of an initial public offering, which is not considered probable under it occurs, no share-based compensation expense was recognized for the fair value of the original awards. As of the date of the modification resulting from the exchange program, incremental compensation expense, which is not classified as share-based compensation expense, will be the fair values of the two new compensation schemes included in the exchange program. Under Scheme I, the modification resulted in total incremental compensation expense of \$5.7 million, which will be recognized in the consolidated statements of comprehensive income ratably over the remaining vesting period of the awards for each tranche. For the three months ended June 30, 2013, compensation expense of \$2.5 million was recognized in the consolidated statements of comprehensive income. For scheme II, the incremental compensation expense will vary depending on 7Road's future financial performance.

## **Taxation**

### ***Income Taxes***

Income taxes are accounted for using an asset and liability approach which requires the recognition of income taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in our financial statements or tax returns. Deferred income taxes are determined based on the differences between the accounting basis and the tax basis of assets and liabilities and are measured using the currently enacted tax rates and laws. Deferred tax assets are reduced by a valuation allowance, if based on available evidence, it is considered that it is more likely than not that some portion of or all of the deferred tax assets will not be realized. In making such determination, we consider factors including future reversals of existing taxable temporary differences, future profitability, and tax planning strategies. If events were to occur in the future that would allow us to realize more of our deferred tax assets than the presently recorded net amount, an adjustment would be made to the deferred tax assets that would increase income for the period when those events occurred. If events were to occur in the future that would require us to realize less of our deferred tax assets than the presently recorded net amount, an adjustment would be made to the valuation allowance against deferred tax assets that would decrease income for the period when those events occurred. Significant management judgment is required in determining income tax expense and deferred tax assets and liabilities.

Our deferred tax assets relate to net operating losses and temporary differences between accounting basis and tax basis for our China-based subsidiaries and VIEs, which are subject to corporate income tax in the PRC under the PRC Corporate Income Tax Law (the "CIT Law").

---

## **Table of Contents**

### ***PRC Withholding Tax on Dividends***

The CIT Law imposes a 10% withholding income tax for dividends distributed by foreign invested enterprises to their immediate holding companies outside mainland China. A lower withholding tax rate will be applied if there is a tax treaty between mainland China and the jurisdiction of the foreign holding company. A holding company in Hong Kong, for example, will be subject to a 5% withholding tax rate under the Arrangement Between the PRC and the Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, (the China-HK Tax Arrangement), if such holding company is considered a non-PRC resident enterprise and holds at least 25% of the equity interests in the PRC foreign invested enterprise distributing the dividends, subject to approval of the PRC local tax authority. However, if the Hong Kong holding company is not considered to be the beneficial owner of such dividends under applicable PRC tax regulations, such dividend may remain subject to a withholding tax rate of 10%.

Changyou's Board of Directors determined to cause one of Changyou's PRC subsidiaries to distribute all of its 2012 earnings and a portion of its 2013 earnings, respectively, to its overseas parent company, Changyou.com HK Limited (Changyou HK). Based on an assessment performed pursuant to requirements specified by PRC tax authorities, Changyou concluded that it was more likely than not that such distribution would be subject to 5% withholding tax. As of June 30, 2013, Changyou had accrued deferred tax liabilities in the amount of \$15.4 million for withholding taxes associated with this distribution plan.

### ***Uncertain Tax Positions***

In order to assess uncertain tax positions, we apply a more likely than not threshold and a two-step approach for tax position measurement and financial statement recognition. For the two-step approach, the first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon settlement.

### ***Transition from PRC Business Tax to PRC Value Added Tax***

Effective September 1, 2012, the Pilot Program for transition from the imposition of Business Tax to the imposition of VAT for revenues from certain industries was expanded from Shanghai to eight other cities and provinces in China, including Beijing and Tianjin. On May 24, 2013, it was announced that commencing August 1, 2013 the Pilot Program will be expanded to all regions in PRC. Our brand advertising and search revenues are subject to this program.

Business Tax had been imposed primarily on revenues from the provision of taxable services, assignments of intangible assets and transfers of real estate. Prior to the implementation of the pilot program, our Business Tax rate, which varies depending upon the nature of the revenues being taxed, generally ranged from 3% to 5%.

VAT payable on goods sold or taxable labor services provided by a general VAT taxpayer for a taxable period is the net balance of the output VAT for the period after crediting the balance of VAT input. Before the implementation of the Pilot Program, we were mainly subject to a small amount of VAT for revenues of Changyou's subsidiary 7Road that are deemed for PRC tax purposes to be derived from the sale of software. VAT has been imposed on those 7Road revenues at a rate of 17%, with a 14% immediate tax refund, resulting in a net rate of 3%. With the implementation of the Pilot Program, in addition to the 7Road revenues, our brand advertising and search revenues are now subject to VAT at a rate of 6%.

Under ASC 605-45, the presentation of taxes on either a gross basis (included in revenues and costs) or a net basis (excluded from revenues) is an accounting policy decision determined by management. As VAT imposed on brand advertising and search revenues and VAT imposed on 7Road's revenues from the sale of software are considered as substantially different in nature, we determined that it is reasonable to apply the guidance separately for these two types of VAT. The basis for this determination is that VAT payable on brand advertising and search revenues is the difference between the output VAT (at a rate of 6%) and available input VAT amount (at the rate applicable to the supplier), which is a component of our costs for providing the brand advertising and search services. On the other hand, VAT payable by 7Road is in effect at 3% of the applicable revenues from the sale of software, irrespective of the availability of any input VAT, under preferential VAT treatment provided to 7Road by the local tax bureau. In this regard, we believe the VAT payable by 7Road is more akin to a sales tax than typical VAT. As a result, we adopted the net presentation method for our brand advertising and search businesses both before and after the implementation of the Pilot Program, and for the revenues of 7Road deemed to be derived from the sale of software we adopted the gross presentation method before and after the implementation of the Pilot Program.

### ***U.S. Corporate Income Tax***

## Edgar Filing: SOHU COM INC - Form 10-Q

Sohu.com Inc. is a Delaware corporation that is subject to U.S. corporate income tax on its taxable income at a rate of 34% or 35%. Subject to certain limitations, the net operating losses ( NOLs ) of a corporation taxable in the U.S. that are carried forward from prior years may be used to offset the corporation's taxable income. As of the end of the 2012 taxable year, Sohu.com Inc. had no further NOLs available for offsetting any U.S. taxable income. Accordingly, to the extent that Sohu.com Inc. has U.S. taxable income in 2013, we will accrue U.S. corporate income tax in our consolidated statements of comprehensive income and make estimated tax payments as and when required by U.S. law.



## **Table of Contents**

### **Net Income per Share**

Basic net income per share is computed using the weighted average number of common shares outstanding during the period. 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 comprise shares issuable upon the exercise or settlement of share-based awards. Potential common shares are accounted for in the computation of diluted earnings per share using the treasury stock method. The dilutive effect of share-based awards with performance requirements is not considered before the performance targets are actually met. The computation of diluted net income per share does not assume conversion, exercise, or contingent issuance of securities that would have an anti-dilutive effect (i.e., an increase in earnings per share amounts or a decrease in loss per share amounts) on net income per share. Additionally, for purposes of calculating the numerator of diluted net income per share, the net income attributable to Sohu is adjusted as follows:

- (1) Changyou's net income attributable to Sohu is determined using the percentage that the weighted average number of Changyou shares held by Sohu represents of the weighted average number of Changyou ordinary shares and shares issuable upon the exercise or settlement of share-based awards under the treasury stock method, instead of by the percentage held by Sohu of the total economic interest in Changyou, which is used for the calculation of basic net income per share.
- (2) Sogou's net income/(loss) attributable to Sohu is determined using the percentage that the weighted average number of Sogou shares held by Sohu represents of the weighted average number of Sogou ordinary shares and Series A Preferred Shares, shares issuable upon the conversion of convertible preferred shares under the if-converted method, and shares issuable upon the exercise or settlement of share-based awards under the treasury stock method, instead of by Sogou's net income/(loss) allocated to Sohu by virtue of the Sogou Series A Terms, the terms of the restructuring and Sohu's purchase of Sogou Series A Preferred Shares from Alibaba, which is used for the calculation of basic net income per share.

### **Fair Value of Financial Instruments**

U.S. GAAP establishes a three-tier hierarchy to prioritize the inputs used in the valuation methodologies in measuring the fair value of financial instruments. This hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three-tier fair value hierarchy is:

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

Level 2 - include other inputs that are directly or indirectly observable in the market place.

Level 3 - unobservable inputs which are supported by little or no market activity.

Our financial instruments include cash equivalents, restricted time deposits, short-term investments, investments in debt securities, accounts receivable, prepaid and other current assets, prepaid non-current assets, accounts payable, accrued liabilities, receipts in advance and deferred revenue, short-term bank loans, other short-term liabilities, long-term accounts payable and long-term bank loans.

### **Cash Equivalents**

Our cash equivalents mainly consist of time deposits placed with banks with an original maturity of three months or less.

### **Restricted time deposits**

Restricted time deposits are valued based on the prevailing interest rates in the market.

### ***Changyou loans from offshore banks, secured by time deposits***

As of June 30, 2013 we had, through Changyou, loans from offshore banks. These loans are secured by RMB deposits in onshore branches of those banks. The loans from the offshore branches of the lending banks are classified as short-term bank loans or long-term bank loans based on their repayment period. The rates of interest under the loan agreements with the lending banks were determined based on the prevailing interest rates in the market. The RMB onshore deposits securing the offshore loans are treated as restricted time deposits on our consolidated balance

sheets.

***Collateral related to Sogou incentive shares trust arrangements***

In February 2013, we deposited \$9 million in cash into restricted time deposit accounts at a bank as collateral for credit facilities provided by the bank to certain Sogou employees. The facilities are intended to fund the employees' early exercise of Sogou share options and related PRC individual income tax. We are not subject to any additional potential payments other than the restricted time deposit amounts, and believe that the fair value of our guarantee liability is immaterial.

## **Table of Contents**

### **Short-term Investments**

For investments in financial instruments with a variable interest rate indexed to the performance of underlying assets, we elected the fair value method at the date of initial recognition and carried these investments subsequently at fair value. Changes in the fair value are reflected in the consolidated statements of comprehensive income.

### **Investments in Debt Securities**

We invest our excess cash in certain debt securities of high-quality corporate issuers. We elected the fair value option to account for our investments in debt securities at their initial recognition. Changes in the fair value are reflected in the consolidated statements of comprehensive income as other income/(expense). The fair value election was made to mitigate accounting mismatches and to achieve operational simplifications.

### **Accounts Receivable, Net**

The carrying value of accounts receivable is reduced by an allowance that reflects our best estimate of the amounts that will not be collected. We make estimations of the collectability of accounts receivable. Many factors are considered in estimating the general allowance, including reviewing delinquent accounts receivable, performing an aging analysis and a customer credit analysis, and analyzing historical bad debt records and current economic trends. Additional allowance for specific doubtful accounts might be made if the financial conditions of our customers or the China mobile network operators deteriorate or the China mobile network operators are unable to collect fees from their end customers, resulting in their inability to make payments due to us.

### **Equity Investments**

Investments in entities over which we do not have significant influence are recorded as equity investments and are accounted for by the cost method. Investments in entities over which we have significant influence but do not control are also recorded as equity investments and are accounted for by the equity method. Under the equity method, our share of the post-acquisition profits or losses of the equity investment is recognized in our consolidated statements of comprehensive income; and our share of post-acquisition movements in equity investments is recognized in equity in our consolidated balance sheets. Unrealized gains on transactions between us and our equity investees are eliminated to the extent of the interest in the equity investments. Unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. When our share of losses in an equity investment equals or exceeds our interest in the equity investment, we do not recognize further losses, unless we have incurred obligations or made payments on behalf of the equity investee.

### **Long-Lived Assets**

Long-lived assets include fixed assets, intangible assets and prepaid non-current assets.

#### ***Fixed Assets***

Fixed assets mainly comprise office building, leasehold improvements, vehicles, office furniture, and computer equipment and hardware. Fixed assets are recorded at cost less accumulated depreciation with no residual value. Depreciation is computed using the straight-line method over the estimated useful lives of the assets.

In May 2013, the office building Sohu purchased in 2009 was placed in service. Accordingly, in the same month, we recognized the office building's original cost of \$162 million as fixed assets. The original cost consists primarily of the purchase price and the costs of technological infrastructure and fitting-out work. Also in May 2013, we began recognizing depreciation expense based on the building's useful life, which is approximately 41 years, on a straight-line basis.

For Changyou's office building purchased in 2010, as of June 30, 2013, \$144 million had been paid and recognized as construction-in-process under fixed assets in our consolidated balance sheets, as the construction work of the building had been completed and the technological infrastructure and fitting-out work was still in progress.

Expenditure for maintenance and repairs is expensed as incurred.

## Edgar Filing: SOHU COM INC - Form 10-Q

The gain or loss on the disposal of fixed assets is the difference between the net sales proceeds and the lower of the carrying value or fair value less cost to sell the relevant assets and is recognized in operating expenses in the consolidated statements of comprehensive income.

---

## **Table of Contents**

### ***Intangible Assets***

Intangible assets mainly comprise video content and license, customer lists, developed technologies, computer software purchased from unrelated third parties, domain names and trademarks, and operating rights for licensed games. Intangible assets are recorded at cost less accumulated amortization with no residual value. Amortization of intangible assets other than licensed video content is computed using the straight-line method over their estimated useful lives.

We amortize licensed video content over the shorter of the term of the estimated period over which the benefits of the license agreement will be enjoyed based on the trend of accumulation of viewership or the applicable license period. Beginning in the third quarter of 2011, licensed video content is amortized on an accelerated basis based on the viewership accumulation trend over the shorter of the term of the estimated period over which the benefits of the license contract will be enjoyed or the applicable license period. For exclusively licensed video content which we sub-licensed to similar platforms in return for payment in cash, we allocate a portion of the video content cost from cost of brand advertising revenues to sub-licensing cost. The allocation is based on the revenues to be generated through sub-licensing. We amortize sub-licensing cost using the individual-film-forecast-computation method, which amortizes such costs in the same ratio that actual sub-licensing revenue bears as of the current period end to the total of the actual revenue earned and the estimated remaining unrecognized ultimate revenue.

### ***Prepaid non-current Assets***

Prepaid non-current assets primarily include prepaid PRC income tax arising from the sale of certain assets associated with the 17173 Business by Sohu to Changyou. Since the sale of the 17173 Business was between entities that are included in our consolidated financial statements, it was considered an intra-entity transaction and, under *ASC 810-10*, income taxes paid should be deferred. Accordingly, we recorded income tax related to the sale of the 17173 Business as prepaid PRC income tax. The prepaid PRC income tax will be amortized over the period of the weighted average remaining life of the 17173 Business-related assets sold to Changyou.

### ***Impairment of Long-lived Assets***

In accordance with *ASC 360-10-35*, we review the carrying values of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Based on the existence of one or more indicators of impairment, we measure any impairment of long-lived assets using the projected discounted cash flow method at the asset group level. The estimation of future cash flows requires significant management judgment based on our historical results and anticipated results and is subject to many factors. The discount rate that is commensurate with the risk inherent in our business model is determined by our management. An impairment loss would be recorded if we determined that the carrying value of long-lived assets may not be recoverable. The impairment to be recognized is measured by the amount by which the carrying values of the assets exceed the fair value of the assets.

### **Goodwill**

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of our acquisitions of interests in our subsidiaries and consolidated VIEs.

We test goodwill for impairment at the reporting unit level on an annual basis as of October 1, and between annual tests when an event occurs or circumstances change that could indicate that the asset might be impaired. Commencing in September 2011, we adopted the Financial Accounting Standards Board ( FASB ) revised guidance on Testing of Goodwill for Impairment. Under this guidance, we have the option to choose whether we will apply the qualitative assessment first and then the quantitative assessment, if necessary, or to apply the quantitative assessment directly. For reporting units applying a qualitative assessment first, we start the goodwill impairment test by assessing qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If we determine that it is more-likely-than-not the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is mandatory. Otherwise, no further testing is required. The quantitative impairment test consists of a comparison of the fair value of goodwill with its carrying value. For reporting units directly applying the quantitative assessment, we perform the goodwill impairment test by quantitatively comparing the fair values of those reporting units to their carrying amounts.

Application of a goodwill impairment test requires significant management judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. The judgment in estimating the fair value of reporting units includes estimating future cash flows, determining appropriate discount rates and making other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for each reporting unit.

### **Mezzanine Equity**

## Edgar Filing: SOHU COM INC - Form 10-Q

On May 11, 2011, Changyou, through its VIE Gamease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road's financial statements on June 1, 2011.

---

**Table of Contents**

On June 21, 2012, 7Road's then Chief Executive Officer surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the then outstanding share capital of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou's interest in 7Road increased to 71.926%.

Our Mezzanine Equity consists of noncontrolling interest in 7Road and a put option pursuant to which the noncontrolling shareholders would have the right to put their ordinary shares in 7Road to Changyou at a pre-determined price if 7Road achieved specified performance milestones before the expiration of the put option and 7Road did not complete an initial public offering on NASDAQ, the NYSE or the HKEX. The put option was due to expire in 2014. Since the occurrence of the sale was not solely within the control of Changyou, we classify the noncontrolling interest as mezzanine equity instead of permanent equity in our and Changyou's consolidated financial statements.

Under ASC 480-10, we calculate, on an accumulative basis from the acquisition date, (i) the amount of accretion that would increase the balance of noncontrolling interest to its estimated redemption value over the period from the date of the Shenzhen 7Road acquisition to the earliest redemption date of the noncontrolling interest in 7Road and (ii) the amount of net profit attributable to noncontrolling shareholders of 7Road based on their ownership percentage. The carrying value of the noncontrolling interest as mezzanine equity is adjusted by an accumulative amount equal to the higher of (i) and (ii).

On May 1, 2013, Changyou entered into an agreement to acquire all of the ordinary shares of 7Road held by the noncontrolling shareholders. The acquisition closed on June 5, 2013. Under ASC 810-10, changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. Following the closing of the acquisition, \$2.4 million, representing the excess of the amount of the mezzanine-classified noncontrolling interest in 7Road over the purchase price as of the closing date, was recorded in our equity accounts.

For the three and six months ended June 30, 2013, accretion charges of \$7.1 million and \$17.8 million, respectively, compared to \$1.1 million and \$2.2 million, respectively, for the three and six months ended June 30, 2012, were recorded in our statements of comprehensive income as net income attributable to the mezzanine-classified noncontrolling interest shareholders of 7Road.

**Comprehensive Income**

Comprehensive income is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. Accumulated other comprehensive income, as presented on our consolidated balance sheets, includes a cumulative foreign currency translation adjustment.

**Functional Currency and Foreign Currency Translation*****Functional Currency***

An entity's functional currency is the currency of the primary economic environment in which it operates, normally that is the currency of the environment in which the entity primarily generates and expends cash. Management's judgment is essential to determine the functional currency by assessing various indicators, such as cash flows, sales price and market, expenses, financing and inter-company transactions and arrangements. The functional currency of Sohu.com Inc. is the U.S. dollar. The functional currency of our subsidiaries in the U.S., the Cayman Islands, the British Virgin Islands and Hong Kong is the U.S. dollar. The functional currencies of our subsidiaries and VIEs in the PRC, the United Kingdom, Malaysia and Korea are the national currencies of those countries.

***Foreign Currency Translation***

Assets and liabilities of our China-based subsidiaries and VIEs, the United Kingdom, Malaysia and Korea are translated into U.S. dollars, our reporting currency, at the exchange rate in effect at the balance sheets date and revenues and expenses are translated at the average exchange rates in effect during the reporting period. Foreign currency translation adjustments are not included in determining net income for the period but are accumulated in a separate component of equity in our consolidated balance sheets.

Foreign currency transactions denominated in currencies other than the functional currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are re-measured at the applicable rates of exchange in effect at that date. Gains and losses resulting from foreign currency re-measurement are included in the consolidated statements of comprehensive income.





**Table of Contents****RESULTS OF OPERATIONS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2013 AND 2012****Reclassification of revenues and costs related to Changyou IVAS**

Commencing January 1, 2013, in order to provide a better foundation for understanding Changyou's performance, both revenues and costs generated from the operation of third-party Web games by the 17173 business were reclassified from the online game business to IVAS in the others business. To conform to current period presentations, the relevant amounts for prior periods have been reclassified accordingly. Such reclassifications amounted to \$1.2 million and \$2.7 million, respectively, for revenues and \$0.4 million and \$1.0 million for costs, respectively, for the three and six months ended June 30, 2012.

**Revenues**

The following table presents our revenues by revenue source and by proportion for the periods indicated (in thousands, except percentages):

	Three Months Ended June 30,					Six Months Ended June 30,				
	2013		2012		2013 vs 2012	2013		2012		2013 vs 2012
Revenues										
Online advertising:										
Brand advertising	\$ 100,191	29%	\$ 69,312	27%	\$ 30,879	\$ 180,428	28%	\$ 130,280	27%	\$ 50,148
Search and others	46,171	14%	28,763	11%	17,408	82,223	13%	50,400	10%	31,823
Subtotal of online advertising										
Revenues	146,362	43%	98,075	38%	48,287	262,651	41%	180,680	37%	81,971
Online game	168,295	50%	135,956	53%	32,339	335,716	52%	261,924	55%	73,792
Mobile	15,313	4%	15,598	6%	(285)	29,086	4%	28,949	6%	137
Others	8,934	3%	6,098	3%	2,836	19,047	3%	10,778	2%	8,269
Total revenues	\$ 338,904	100%	\$ 255,727	100%	\$ 83,177	\$ 646,500	100%	\$ 482,331	100%	\$ 164,169

Total revenues were \$338.9 million and \$646.5 million, respectively, for the three and six months ended June 30, 2013, compared to \$255.7 million and \$482.3 million, respectively, for the corresponding periods in 2012. The increase in total revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$83.2 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$164.2 million. The increases were mainly attributable to increases in online advertising revenues and online game revenues.

**Online Advertising Revenues**

Online advertising revenues were \$146.4 million and \$262.7 million, respectively, for the three and six months ended June 30, 2013, compared to \$98.1 million and \$180.7 million, respectively, for the corresponding periods in 2012. The increase in online advertising revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$48.3 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$82.0 million. The increases were mainly attributable to increases in brand advertising revenues and search and others revenues.

**Brand Advertising Revenues**

Brand advertising revenues were \$100.2 million and \$180.4 million, respectively, for the three and six months ended June 30, 2013, compared to \$69.3 million and \$130.3 million, respectively, for the corresponding periods in 2012. The increase in brand advertising revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$30.9 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$50.1 million. The increases were mainly attributable to an increase in revenues from the

## Edgar Filing: SOHU COM INC - Form 10-Q

sectors of real estate and fast-moving consumer goods industries.

We expect brand advertising revenues to increase in the third quarter of 2013, compared to the second quarter of 2013.

**Table of Contents***Search and Others Revenues*

Search and others revenues were \$46.2 million and \$82.2 million, respectively, for the three and six months ended June 30, 2013, compared to \$28.8 million and \$50.4 million, respectively, for the corresponding periods in 2012. The increase in search and others revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$17.4 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$31.8 million. The increases were mainly contributed by pay-for-click services, as well as online marketing services on the Sogou Web Directory, both as a result of increased traffic and improved monetization of traffic.

We expect search and others revenues to increase in the third quarter of 2013, compared to the second quarter of 2013.

*Online Game Revenues*

Online game revenues were \$168.3 million and \$335.7 million, respectively, for the three and six months ended June 30, 2013, compared to \$136.0 million and \$261.9 million, respectively, for the corresponding periods in 2012. The increase in online game revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$32.3 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$73.8 million. The increases were mainly due to the growth of TLBB and Wartune in the second quarter of 2013.

We expect online game revenues to decrease in the third quarter of 2013, compared to the second quarter of 2013.

*Mobile Revenues*

Mobile revenues were \$15.3 million and \$29.1 million, respectively, for the three and six months ended June 30, 2013, compared to \$15.6 million and \$28.9 million, respectively, for the corresponding periods in 2012. The decrease in mobile revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$0.3 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$0.2 million.

We expect mobile revenues to be flat in the third quarter of 2013 compared to the second quarter of 2013.

*Others Revenues*

Revenues for other services were \$8.9 million and \$19.0 million, respectively, for the three and six months ended June 30, 2013, compared to \$6.1 million and \$10.8 million, respectively, for the corresponding periods in 2012. The increase in others revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$2.8 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$8.2 million. The increases were mainly due to increased revenues from IVAS and the cinema advertisement business.

**Costs and Expenses***Cost of Revenues*

The following table presents our cost of revenues by source and by proportion for the periods indicated (in thousands, except percentages):

	Three Months Ended June 30,				Six Months Ended June 30,					
	2013	2012	2013 vs 2012	2013	2012	2013 vs 2012	2012	2013 vs 2012		
Cost of revenues:										
Online advertising:										
Brand advertising	\$ 51,556	45%	\$ 50,963	51%	\$ 593	\$ 96,434	44%	\$ 87,855	49%	\$ 8,579
Search and others	24,498	22%	16,192	16%	8,306	45,290	21%	29,320	16%	15,970
Subtotal of cost of online advertising revenues	76,054	67%	67,155	67%	8,899	141,724	65%	117,175	65%	24,549

Edgar Filing: SOHU COM INC - Form 10-Q

Online game	22,981	20%	17,891	18%	5,090	45,630	21%	33,722	19%	11,908
Mobile	8,963	8%	10,208	10%	(1,245)	18,235	9%	19,061	11%	(826)
Others	5,647	5%	4,590	5%	1,057	11,585	5%	9,408	5%	2,177
<b>Total cost of revenues</b>	<b>\$ 113,645</b>	<b>100%</b>	<b>\$ 99,844</b>	<b>100%</b>	<b>\$ 13,801</b>	<b>\$ 217,174</b>	<b>100%</b>	<b>\$ 179,366</b>	<b>100%</b>	<b>\$ 37,808</b>

---

**Table of Contents**

Total cost of revenues was \$113.6 million and \$217.2 million, respectively, for the three and six months ended June 30, 2013, compared to \$99.8 million and \$179.4 million, respectively, for the corresponding periods in 2012. The increase in cost of revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$13.8 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$37.8 million. The increases were mainly attributable to increases in cost of online advertising revenues and cost of online game revenues.

*Cost of Online Advertising Revenues*

Cost of online advertising revenues was \$76.1 million and \$141.7 million, respectively, for the three and six months ended June 30, 2013, compared to \$67.2 million and \$117.2 million, respectively, for the corresponding periods in 2012. The increase in cost of online advertising revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$8.9 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$24.5 million. The increases were mainly attributable to increases in cost of search and others revenues.

*Cost of Brand Advertising Revenues*

Cost of brand advertising revenues mainly consists of content and license costs (including amortization of licensed video content and impairment of purchased video content), bandwidth leasing costs, salary and benefits expenses, and depreciation expenses.

Cost of brand advertising revenues was \$51.6 million and \$96.4 million, respectively, for the three and six months ended June 30, 2013, compared to \$51.0 million and \$87.9 million, respectively, for the corresponding periods in 2012.

The increase in cost of brand advertising revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$0.6 million. The increase mainly consisted of a \$6.6 million increase in amortization of content and license costs, a \$4.4 million increase in salary and benefits expenses, a \$2.4 million increase in bandwidth leasing costs, and a \$2.2 million increase in depreciation expenses, offset by a \$15.3 million impairment of purchased video content in the second quarter of 2012.

The increase in cost of brand advertising revenues from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$8.5 million. The increase mainly consisted of a \$10.1 million increase in amortization of content and license costs, a \$7.9 million increase in salary and benefits expenses, a \$3.0 million increase in depreciation expenses, and a \$2.9 million increase in bandwidth leasing costs, offset by a \$15.3 million impairment of purchased video content in the second quarter of 2012.

Our brand advertising gross margin was 49% and 47%, respectively, for the three and six months ended June 30, 2013, as compared to 26% and 33%, respectively, for the corresponding periods in 2012. The increase in our brand advertising gross margin was mainly due to a \$15.3 million impairment of purchased video content that we recognized in the second quarter of 2012, and relatively slower growth in the rate of brand advertising costs compared with the growth in revenues.

*Cost of Search and Others Revenues*

Cost of search and others revenues mainly consists of traffic acquisition costs, bandwidth leasing costs, depreciation expenses, as well as salary and benefits expenses.

Cost of search and others revenues was \$24.5 million and \$45.3 million, respectively, for the three and six months ended June 30, 2013, compared to \$16.2 million and \$29.3 million, respectively, for the corresponding periods in 2012.

The increase in cost of search and others revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$8.3 million. The increase mainly consisted of a \$5.2 million increase in traffic acquisition costs, a \$1.7 million increase in bandwidth leasing costs along with increased traffic volume, and a 1.1 million increase in depreciation expenses.

The increase in cost of search and others revenues from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$16.0 million. The increase mainly consisted of a \$10.2 million increase in traffic acquisition costs, a \$2.5 million increase in depreciation expenses, and a \$2.5 million increase in bandwidth leasing costs along with increased traffic volume.

Our search and others gross margin was 47% and 45%, respectively, for the three and six months ended June 30, 2013, as compared to 44% and 42%, respectively, for the corresponding periods in 2012. The increase in our search and others gross margin was mainly due to higher revenues

## Edgar Filing: SOHU COM INC - Form 10-Q

from increased traffic and the improved monetization of traffic, as well as traffic acquisition costs constituting a lower percentage of search and others revenues.

### *Cost of Online Game Revenues*

Cost of online game revenues mainly consists of salary and benefits expenses, bandwidth leasing costs, depreciation and amortization expenses, Business Tax and VAT arising from transactions between Changyou's subsidiaries and its VIEs, and revenue-based royalty payments to game developers.

---

**Table of Contents**

Cost of online game revenues was \$23.0 million and \$45.6 million, respectively, for the three and six months ended June 30, 2013, compared to \$17.9 million and \$33.7 million, respectively, for the corresponding periods in 2012.

The increase in cost of online game revenues from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$5.1 million. The increase mainly consisted of a \$2.2 million increase in salary and benefits expenses, a \$1.4 million increase in bandwidth leasing costs, and a \$1.3 million increase in Business Tax and 7Road VAT.

The increase in cost of online game revenues from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$11.9 million. The increase mainly consisted of a \$5.5 million increase in salary and benefits expenses, a \$2.7 million increase in Business Tax and 7Road VAT, and a \$2.6 million increase in bandwidth leasing costs.

Our online game gross margin was 86% for both the three months and the six months ended June 30, 2013, as compared to 87% for both of the corresponding periods in 2012.

*Cost of Mobile Revenues*

Cost of mobile revenues mainly consists of revenue-sharing payments (which include payments to third party mobile service alliances and content providers), collection charges and transmission fees paid to China mobile network operators, bandwidth leasing costs and depreciation expenses.

Cost of mobile revenues was \$9.0 million and \$18.2 million, respectively, for the three and six months ended June 30, 2013, compared to \$10.2 million and \$19.1 million, respectively, for the corresponding periods in 2012. The decrease in cost of mobile revenues from the three and six months ended June 30, 2012 to the three and six months ended June 30, 2013 was \$1.2 million and \$0.9 million, respectively. The decreases were mainly due to decreased collection charges and transmission fees paid to China mobile network operators.

The collection charges and transmission fees varied between China mobile network operators. The collection charges and transmission fees mainly include (i) a gateway fee of \$0.008 to \$0.032 per message in both the second quarter of 2013 and 2012, depending on the volume of the monthly total mobile messages, and (ii) a collection fee of 15% to 87% of total fees collected by China mobile network operators from mobile phone users (with the residual paid to us) in both the second quarter of 2013 and 2012.

Our mobile gross margin was 41% and 37%, respectively, for the three and six months ended June 30, 2013, as compared to 35% and 34%, respectively, for the corresponding periods in 2012. The increases in our mobile gross margin were mainly due to decreased collection charges.

*Cost of Revenues for Other Services*

Cost of revenues for other services mainly consists of payments to theatres and film production companies for pre-film screening advertisement slots, revenue-sharing payments related to IVAS business, and amortization of sub-licensing cost.

Cost of revenues for other services was \$5.6 million and \$11.6 million, respectively, for the three and six months ended June 30, 2013, compared to \$4.6 million and \$9.4 million, respectively, for the corresponding periods in 2012. The increase in cost of revenues for other services from the three and six months ended June 30, 2012 to the three and six months ended June 30, 2013 was \$1.0 million and \$2.2 million, respectively. The increases were mainly due to payments for the cinema advertisement business and amortization of sub-licensing cost.

**Table of Contents****Operating Expenses**

The following table presents our operating expenses by nature and by proportion for the periods indicated (in thousands, except percentages):

	Three Months Ended June 30,				Six Months Ended June 30,							
	2013		2012		2013 vs 2012		2013		2012		2013 vs 2012	
Operating expenses:												
Product development	\$ 63,361	39%	\$ 43,340	38%	\$ 20,021	\$ 115,180	39%	\$ 81,933	39%	\$ 33,247		
Sales and marketing	71,678	45%	48,999	43%	22,679	130,401	45%	87,653	42%	42,748		
General and administrative	25,772	16%	17,508	16%	8,264	48,361	16%	35,302	17%	13,059		
Impairment of intangible assets via acquisition of businesses (1)	0	0%	2,906	3%	(2,906)	0	0%	2,906	2%	(2,906)		
Total operating expenses	\$ 160,811	100%	\$ 112,753	100%	\$ 48,058	\$ 293,942	100%	\$ 207,794	100%	\$ 86,148		

Note (1): In the second quarter of 2012, we recognized a \$2.9 million impairment loss in Changyou for intangible assets recognized from acquired businesses.

Total operating expenses were \$160.8 million and \$293.9 million, respectively, for the three and six months ended June 30, 2013, compared to \$112.8 million and \$207.8 million, respectively, for the corresponding periods in 2012. The increase in operating expenses from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$48 million, and the increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$86.1 million. The increases were mainly due to increases in sales and marketing expenses and product development expenses.

**Product Development Expenses**

Product development expenses mainly consist of personnel-related expenses incurred for enhancement and maintenance of our Websites, and costs associated with new product development and maintenance, as well as enhancement of existing products and services, which mainly include the development costs of online games prior to the establishment of technological feasibility and maintenance costs after the online games are available for marketing.

Product development expenses were \$63.4 million and \$115.2 million, respectively, for the three and six months ended June 30, 2013, compared to \$43.3 million and \$81.9 million, respectively, for the corresponding periods in 2012.

The increase in product development expenses from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$20.1 million. The increase mainly consisted of a \$17.1 million increase in salary and benefits expenses, which was mainly attributable to an increased number of employees and increased average compensation, a \$0.8 million increase in professional fees, offset by a \$1.1 million decrease in share-based compensation expense.

The increase in product development expenses from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$33.3 million. The increase mainly consisted of a \$30.7 million increase in salary and benefits expenses, which was mainly attributable to an increased number of employees and increased average compensation, a \$1.2 million increase in professional fees, offset by a \$2.0 million decrease in share-based compensation expense.

**Sales and Marketing Expenses**

Sales and marketing expenses mainly consist of advertising and promotional expenditures, salary and benefits expenses, travel expenses, and facility expenses.

Sales and marketing expenses were \$71.7 million and \$130.4 million, respectively, for the three and six months ended June 30, 2013, compared to \$49.0 million and \$87.7 million, respectively, for the corresponding periods in 2012.



## Edgar Filing: SOHU COM INC - Form 10-Q

The increase in sales and marketing expenses from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$22.7 million. The increase mainly consisted of a \$10.5 million increase in advertising and promotional expenditures, a \$9.8 million increase in salary and benefits expenses, which was mainly attributable to an increased number of employees and increased average compensation, and a \$2.2 million increase in travel expenses.

The increase in sales and marketing expenses from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$42.7 million. The increase mainly consisted of a \$20.6 million increase in advertising and promotional expenditures, an \$18.2 million increase in salary and benefits expenses, which was mainly attributable to an increased number of employees and increased average compensation, and a \$3.4 million increase in travel expenses.

**Table of Contents***General and Administrative Expenses*

General and administrative expenses mainly consist of salary and benefits expenses, professional service fees, travel expenses, and facility expenses.

General and administrative expenses were \$25.8 million and \$48.4 million, respectively, for the three and six months ended June 30, 2013, compared to \$17.5 million and \$35.3 million, respectively, for the corresponding periods in 2012.

The increase in general and administrative expenses from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$8.3 million. The increase mainly consisted of a \$6.1 million increase in salary and benefits expenses, which was mainly attributable to an increased number of employees and increased average compensation, a \$2.6 million increase in professional service fees, and a \$1.1 million increase in travel expenses, offset by a \$0.9 million decrease in share-based compensation expense, and a \$0.8 million decrease in bad debt expense.

The increase in general and administrative expenses from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$13.1 million. The increase mainly consisted of an \$8.7 million increase in salary and benefits expenses, which was mainly attributable to an increased number of employees and increased average compensation, a \$6.2 million increase in professional service fees, and a \$2.3 million increase in travel expenses, offset by a \$3.7 million decrease in bad debt expense, and a \$1.4 million decrease in share-based compensation expense.

*Share-based Compensation Expense*

Sohu, Changyou, Sogou, Sohu Video and 7Road all have incentive plans for the granting of share-based awards, including common stock /ordinary shares, share options, restricted shares and restricted share units, to their employees and directors.

Share-based compensation expense was recognized in costs and/or expenses for the three and six months ended June 30, 2013 and June 30, 2012, respectively, as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Share-based compensation expense				
Cost of revenues (1)	\$ 98	\$ (76)	\$ 168	\$ 194
Product development expenses	408	1,531	758	2,703
Sales and marketing expenses	201	497	373	1,031
General and administrative expenses	532	1,477	1,026	2,431
	\$ 1,239	\$ 3,429	\$ 2,325	\$ 6,359

Note (1): In the second quarter of 2012, share-based compensation expense was trued up for forfeited restricted share units which would have become fully vested during the quarter.

Share-based compensation expense recognized for share awards of Sohu, Changyou and Sogou, was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Share-based compensation expense				
For Sohu share-based awards	\$ 722	\$ 1,478	\$ 1,583	\$ 3,181
For Changyou share-based awards	363	813	572	2,019
For Sogou share-based awards	154	1,138	170	1,159
	\$ 1,239	\$ 3,429	\$ 2,325	\$ 6,359

For Sohu share options, as of June 30, 2013 there was no unrecognized compensation expense because the requisite service periods for the remaining share options had ended by the end of 2009. For Sohu restricted share units, as of June 30, 2013 there was \$1.7 million of

## Edgar Filing: SOHU COM INC - Form 10-Q

unrecognized compensation expense.

For Changyou share-based awards, as of June 30, 2013, there was \$1.3 million of unrecognized compensation expense.

For Sogou share-based awards, as of June 30, 2013, there was \$2.2 million of unrecognized compensation expense.

There was no share-based compensation expense recognized for the share-based awards of Sohu Video and 7Road for any of the periods presented in the above table.

## **Table of Contents**

### ***Operating Profit***

As a result of the foregoing, our operating profit was \$64.4 million and \$135.4 million, respectively, for the three and six months ended June 30, 2013, compared to \$43.1 million and \$95.2 million, respectively, for the corresponding periods in 2012.

### ***Other Income***

Other income was \$1.5 million and \$4.1 million, respectively, for the three and six months ended June 30, 2013, compared to other income of \$1.8 million and \$3.4 million, respectively, for the corresponding periods in 2012.

### ***Interest Income***

Interest income was \$5.5 million and \$12.2 million, respectively, for the three and six months ended June 30, 2013, compared to \$7.2 million and \$13.7 million, respectively, for the corresponding periods in 2012.

### ***Income Tax Expense***

Income tax expense was \$16.3 million and \$36.3 million, respectively, for the three and six months ended June 30, 2013, compared to \$18.5 million and \$37.2 million, respectively, for the corresponding periods in 2012.

The decrease in income tax expense from the three and six months ended June 30, 2012 to the corresponding periods in 2013 was \$2.2 million and \$0.9 million, respectively. The \$2.2 million decrease was mainly due to decreases in withholding tax for Changyou.

### ***Net Income***

For the three and six months ended June 30, 2013, we had net income of \$53.2 million and \$111.4 million, respectively, compared to \$33.7 million and \$74.6 million, respectively, for the corresponding periods of 2012.

### ***Net Income Attributable to Noncontrolling Interest***

Net income attributable to noncontrolling interest was \$24.5 million and \$47.6 million, respectively, for the three and six months ended June 30, 2013, compared to \$19.9 million and \$36.5 million, respectively, for the corresponding periods in 2012.

The increase in net income attributable to noncontrolling interest from the three months ended June 30, 2012 to the three months ended June 30, 2013 was \$4.6 million, of which \$2.5 million and \$2.4 million were contributed by Changyou and Sogou, respectively. The increase from the six months ended June 30, 2012 to the six months ended June 30, 2013 was \$11.1 million, of which \$7.9 million and \$3.6 million were contributed by Changyou and Sogou, respectively.

We expect the noncontrolling interest recognized for Changyou to decrease in the third quarter of 2013, compared to the second quarter of 2013. We expect the noncontrolling interest recognized for Sogou to remain at a low level.

### ***Net Income attributable to Sohu.com Inc.***

As a result of the foregoing, we had net income attributable to Sohu of \$21.6 million and \$46.1 million, respectively, for the three and six months ended June 30, 2013, compared to \$12.8 million and \$35.9 million, respectively, for the corresponding periods in 2012.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Resources Analysis**

Our principal sources of liquidity are cash and cash equivalents, short-term investments, investments in debt securities, as well as the cash flows generated from our operations. Cash equivalents primarily comprise time deposits. As of June 30, 2013, we had cash and cash equivalents, short-term investments and investments in debt securities of approximately \$948.6 million. In addition, as of June 30, 2013, we had \$343 million cash in the form of restricted time deposits, of which \$333 million consisted of RMB deposits in onshore banks related to Changyou bank loans

from offshore banks in the principal amount of \$323 million.

**Table of Contents**

As of June 30, 2013, we had commitments for bandwidth purchases in the amount of \$45 million, commitments for video content purchases in the amount of \$36 million, commitments for operating leases in the amount of \$26 million and commitments for other content and service purchases in the amount of \$20 million. In addition, for Changyou's office building purchased in 2010, \$144 million of the \$163 million purchase price had been paid as of June 30, 2013 and the remaining \$19 million is expected to be settled by the end of 2013.

On July 27, 2013, Changyou's Board of Directors authorized a share repurchase program of up to \$100 million of the outstanding ADSs of Changyou over a two-year period from July 27, 2013 to July 26, 2015.

We believe our current liquidity and capital resources are sufficient to meet anticipated working capital needs (net cash used in operating activities), commitments and capital expenditures over the next twelve months. We may, however, require additional cash resources due to changes in business conditions and other future developments, or changes in general economic conditions.

**Cash Generating Ability**

We believe we will continue to generate strong cash flow from online game business, which, along with our available cash, will provide sufficient liquidity and financial flexibility.

Our cash flows were summarized below (in thousands):

	<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
Net cash provided by operating activities	\$ 151,726	\$ 135,807
Net cash used in investing activities	(294,971)	(68,192)
Net cash provided by/(used in) financing activities	68,462	(34,599)
Effect of exchange rate change on cash and cash equivalents	11,790	(1,025)
Net (decrease) /increase in cash and cash equivalents	(62,993)	31,991
Cash and cash equivalents at beginning of period	833,535	732,607
Cash and cash equivalents at end of period	\$ 770,542	\$ 764,598

***Net Cash Provided by Operating Activities***

For the six months ended June 30, 2013, \$151.7 million net cash provided by operating activities was primarily attributable to our net income of \$111.4 million, adjusted by non-cash items of depreciation and amortization of \$56.1 million, share-based compensation expense of \$2.3 million, and impairment of other intangible assets of \$1.4 million, offset by a decrease in cash from working capital items of \$15.0 million, investment income from investments in debt securities of \$2.7 million, and other miscellaneous expenses of \$1.8 million.

For the six months ended June 30, 2012, \$135.8 million net cash provided by operating activities was primarily attributable to our net income of \$74.6 million, adjusted by non-cash items consisting of depreciation and amortization of \$52.4 million, impairment of purchased video content of \$15.3 million, share-based compensation expense of \$6.4 million, and other miscellaneous non-cash expense of \$6.4 million, offset by a decrease in cash from working capital items of \$14.1 million, investment income from investments in debt securities of \$2.7 million and excess tax benefits of \$2.5 million.

In accordance with U.S. GAAP, the above excess tax benefits were presented as a reduction in cash flows from operating activities and a cash inflow from financing activities. Realizing these benefits reduces the amount of taxes payable and does not otherwise affect cash flows.

***Net Cash Used in Investing Activities***

For the six months ended June 30, 2013, \$295.0 million net cash used in investing activities was primarily attributable to \$87.6 million used to acquire fixed assets and intangible assets, \$76.0 million used in the purchase of the noncontrolling interest in 7Road, \$82.0 million in restricted time deposits used as collateral for Changyou loans from offshore banks, \$9.0 million in restricted time deposits used as collateral for credit facilities provided by banks to certain Sogou employees, \$40.7 million used for short-term investments, and \$2.4 million used for investment

## Edgar Filing: SOHU COM INC - Form 10-Q

related to other investing activities, offset by investment income from investments in debt securities of \$2.7 million.

For the six months ended June 30, 2012, \$68.2 million net cash used in investing activities was primarily attributable to \$60.1 million used in acquiring fixed assets and intangible assets, \$6.5 million used in business acquisition and investing activities, and \$4.3 million used for short-term investments, offset by investment income from investments in debt securities of \$2.7 million.

**Table of Contents*****Net Cash Provided by / (Used in) Financing Activities***

For the six months ended June 30, 2013, \$68.5 million net cash provided by financing activities was primarily attributable to \$81.0 million of Changyou loans from offshore banks, \$5.3 million in proceeds received from early exercise of share-based awards in our majority-owned subsidiary Sogou, \$1.3 million from the exercise of share-based awards in Sogou, and \$0.8 million from the issuance of common stock upon the exercise of share options granted under our stock incentive plan, offset by \$19.7 million used for contingent consideration paid by Changyou to 7Road's noncontrolling shareholders, and \$0.2 million used for other cash payments related to financing activities.

For the six months ended June 30, 2012, \$34.6 million net cash used in financing activities was primarily attributable to \$25.8 million used for the purchase of Sogou Series A Preferred Shares from Alibaba, \$12.6 million used for the repurchase of our common stock and \$0.2 million from other cash payments relating to financing activities, offset by \$2.5 million of excess tax benefits, \$1.4 million from the exercise of share-based awards in Sogou, and \$0.1 million from the issuance of common stock upon the exercise of share options granted under our stock incentive plan.

**Restrictions and Limitations on Cash Available to Sohu.com Inc.**

To fund any cash requirements it may have, Sohu.com Inc. may need to rely on dividends and other distributions on equity paid by our wholly-owned subsidiary Sohu.com Limited or our majority-owned subsidiary Changyou.com Limited. Since substantially all of our operations are conducted through our indirect wholly-owned and majority-owned China-based subsidiaries and VIEs, Sohu.com Limited and Changyou.com Limited may need to rely on dividends, loans or advances made by our PRC subsidiaries in order to make dividends and other distributions to us.

The ability of Sohu.com Limited and Changyou.com Limited to receive dividends and distributions from our China-based subsidiaries and VIEs, and the amount of cash available for distribution to, and use by, Sohu.com Inc., are subject to certain restrictions and limitations related to PRC law, our VIE structure and U.S. corporate income tax. We do not expect any of such restrictions or taxes to have a material impact on our ability to meet our cash obligations.

***PRC profit appropriation, withholding tax on dividends and regulation of foreign currency exchange***

Regulations in the PRC currently permit payment of dividends of a PRC company only out of accumulated profits as determined in accordance with accounting standards and regulations in China. Our China-based subsidiaries, which are wholly foreign-owned enterprises ( WFOEs ) under PRC law, are also required to set aside each year to their general reserves at least 10% of their after-tax profit based on PRC accounting standards, until the cumulative amount reaches 50% of their paid-in capital. These reserves may not be distributed as cash dividends, or as loans or advances. Our WFOEs may also allocate a portion of their after-tax profits, at the discretion of their Boards of Directors, to their staff welfare and bonus funds. Any amounts so allocated may not be distributed to Sohu.com Limited or Changyou.com Limited and, accordingly, would not be available for distribution to Sohu.com Inc.

The PRC CIT Law generally imposes a 10% withholding tax on dividends distributed by WFOEs to their immediate holding companies outside mainland China, provided that a lower rate may apply under tax treaties between mainland China and other jurisdictions. For example, withholding tax for dividends to a holding company in Hong Kong may, under certain circumstances, be 5% rather than 10%. As of June 30, 2013, we had accrued deferred tax liabilities in the amount of \$15.4 million for withholding taxes associated with dividends paid by Changyou's mainland China-based WFOEs to Changyou's Hong Kong subsidiary.

Under regulations of the PRC State Administration of Foreign Exchange ( SAFE ), the RMB is not convertible into foreign currencies for capital account items, such as loans, repatriation of investments and investments outside of mainland China, unless prior approval of the SAFE is obtained and prior registration with the SAFE is made.

***PRC restrictions related to our VIE structure***

While generally our VIEs generate revenues and cash, almost all of our VIEs, with the exception of those related to Changyou's online game business, incur deficits as a result of significant costs involved in their operations, and had negative operating cash flow for the three and six months ended June 30, 2013.

Substantially all of Changyou's operations are conducted through its VIEs, which generate all of Changyou's online game revenues. Although Changyou's subsidiaries received a majority of the VIEs' profits pursuant to contractual agreements between the VIEs and Changyou's PRC subsidiaries providing for payments to the subsidiaries in return for services provided to the VIEs by the PRC subsidiaries, significant cash



## Edgar Filing: SOHU COM INC - Form 10-Q

balances remained in Changyou's VIEs as of June 30, 2013. As Changyou's VIEs are not owned by Changyou's PRC subsidiaries, the VIEs are not able to make dividend payments to the subsidiaries.

**Table of Contents**

Therefore, in order for Sohu.com Inc. or our subsidiaries outside of mainland China to receive any dividends, loans or advances from Changyou's PRC subsidiaries, we will need to rely on these contractual payments made by Changyou's VIEs to Changyou's PRC subsidiaries. Depending on the nature of services provided by Changyou's PRC subsidiaries to their corresponding VIEs, certain of these payments will be subject to PRC taxes, including Business Tax and VAT, which will effectively reduce the amount that the PRC subsidiary receives from its corresponding VIE. In addition, the PRC government could impose restrictions on such payments or change the tax rates applicable to such payments.

***U.S. corporate income tax***

Sohu.com Inc. is a Delaware corporation and is subject to corporate income tax in the United States. Although in the past Sohu.com Inc. has been able to use NOLs to offset a portion of its U.S. taxable income, at the end of its 2012 taxable year it had no further NOLs available for offsetting any U.S. taxable income. The majority of our subsidiaries and VIEs are based in China and are subject to income taxes in the PRC. These China-based subsidiaries and VIEs conduct substantially all of our operations and, as a result, we generate most of our consolidated income in China. The amount of cash derived from our operations that can be used to buy back our shares of common stock in the market, paid as dividends to Sohu.com Inc.'s shareholders or used for other corporate purposes of Sohu.com Inc. may be limited by the imposition of U.S. corporate income tax on Sohu.com Inc.'s income.

In accordance with U.S. GAAP, we do not provide for U.S. federal income taxes or tax benefits on the undistributed earnings or losses of our non-U.S. subsidiaries or consolidated VIEs because, for the foreseeable future, we do not have the intention to repatriate those undistributed earnings or losses to the U.S. However, certain activities conducted in the PRC may give rise to U.S. corporate income tax, even if there are no distributions to Sohu.com Inc. U.S. corporate income taxes would be imposed on Sohu.com Inc. when its subsidiaries that are controlled foreign corporations (CFCs) generate income that is subject to Subpart F of the U.S. Internal Revenue Code (Subpart F). Passive income, such as rents, royalties, interest and dividends, is among the types of income subject to taxation under Subpart F. Any income taxable under Subpart F is taxable in the U.S. at federal corporate income tax rates of up to 34% or 35%. Subpart F income also includes certain income from intercompany transactions between Sohu.com Inc.'s non-U.S. subsidiaries and VIEs and Changyou's non-U.S. subsidiaries and VIEs, or where Sohu.com Inc.'s non-U.S. subsidiaries or VIEs make an investment in U.S. property, such as holding the stock in, or making a loan to, a U.S. corporation. Under a temporary provision of the U.S. tax code commonly referred to as the CFC look-through rule, Sohu.com Inc. has not had to treat dividends received by its CFC subsidiaries as Subpart F income includible in Sohu.com Inc.'s taxable income in the U.S. The CFC look-through rule, which is currently scheduled to expire for taxable years beginning after December 31, 2013, has been extended several times by the U.S. Congress. Unless further extended, the CFC look-through rule will be available for Sohu.com Inc.'s CFC subsidiaries and their VIEs only through their taxable years ending November 30, 2014.

**Dividend Policy**

The Sohu Group intends to retain all available funds and any future earnings for use in the operation and expansion of its own business, and does not anticipate paying any cash dividends on Sohu.com Inc.'s common stock or causing Changyou to pay any dividends on Changyou.com Limited's ordinary shares, including ordinary shares represented by Changyou.com Limited's ADSs, for the foreseeable future. Future cash dividends distributed by Sohu.com Inc. and Changyou.com Limited, if any, will be declared at the discretion of their respective Boards of Directors and will depend upon their future operations and earnings, capital requirements and surplus, general financial condition, contractual restrictions and such other factors as their respective Boards of Directors may deem relevant.

**OFF-BALANCE SHEET COMMITMENTS AND ARRANGEMENTS**

We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of third parties, except for a \$9 million restricted time deposit acting as collateral for credit facilities provided by a bank to certain Sogou employees. We are not subject to any additional potential payments other than the restricted time deposit amount, and believe that the fair value of our guarantee liability is immaterial. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholder's equity, or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or that engages in leasing, hedging or product development services with us.

**IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS**

None.



**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK  
FOREIGN CURRENCY EXCHANGE RATE RISK**

While our reporting currency is the U.S. dollar, to date the majority of our revenues and costs are denominated in RMB and a significant portion of our assets and liabilities are denominated in RMB. As a result, we are exposed to foreign exchange risk as our revenues and results of operations may be affected by fluctuations in the exchange rate between the U.S. dollar and the RMB. If the RMB depreciates against the U.S. dollar, the value of our RMB revenues and assets as expressed in our U.S. dollar financial statements will decline. We do not hold any derivative or other financial instruments that expose us to substantial market risk.

The RMB is currently freely convertible under the current account, which includes dividends, trade and service-related foreign exchange transactions, but not under the capital account, which includes foreign direct investment. In addition, commencing on July 21, 2005, China reformed its exchange rate regime by changing to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Under the managed floating exchange rate regime, the RMB is no longer pegged to the U.S. dollar. The exchange rate of the RMB against the U.S. dollar was adjusted to RMB8.11 per U.S. dollar as of July 21, 2005, representing an appreciation of about 2%. The People's Bank of China will announce the closing prices of foreign currencies such as the U.S. dollar traded against the RMB in the inter-bank foreign exchange market after the closing of the market on each business day, and will make such prices the central parity for trading against the RMB on the following business day. On May 19, 2007, the People's Bank of China announced a policy to expand the maximum daily floating range of RMB trading prices against the U.S. dollar in the inter-bank spot foreign exchange market from 0.3% to 0.5%. While the international reactions to the RMB revaluation and widening of the RMB's daily trading band have generally been positive, with the increased floating range of the RMB's value against foreign currencies, the RMB may appreciate or depreciate significantly in value against the U.S. dollar or other foreign currencies in the long term, depending on the fluctuation of the basket of currencies against which it is currently valued.

On June 19, 2010, the People's Bank of China announced that it has decided to proceed further with the reform of the RMB exchange rate regime to enhance the flexibility of the RMB exchange rate and that emphasis would be placed on reflecting market supply and demand with reference to a basket of currencies. While so indicating its intention to make the RMB's exchange rate more flexible, the People's Bank of China ruled out any sharp fluctuations in the currency or a one-off adjustment. As a result of the announcement, the RMB has appreciated significantly. In early August 2013, the center point of the currency's official trading band hit 6.1778, representing appreciation of more than 10.5%. In the long term, the RMB may appreciate or depreciate more significantly in value against the U.S. dollar or other foreign currencies depending on the market supply and demand with reference to a basket of currencies.

To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure. Accordingly, we may incur economic losses in the future due to foreign exchange rate fluctuations, which could have a negative impact on our financial condition and results of operations.

The following table sets forth a summary of our foreign currency sensitive financial instruments as of June 30, 2013, which consisted of cash and cash equivalents, restricted time deposits, short-term investments, investments in debt securities, accounts receivable, prepaid and other current assets, current liabilities, long-term accounts payable and long-term bank loans. These financial instruments are recorded at their fair value.

	Denominated in (in thousands)				Total
	US\$	RMB	HK\$	Others	
Cash and cash equivalents	219,619	549,293	696	934	770,542
Restricted time deposits	9,240	333,274	0	0	342,514
Short-term investments	0	97,123	0	0	97,123
Investment in debt securities	0	80,923	0	0	80,923
Accounts receivable	1,439	136,794	64	315	138,612
Prepaid and other current assets	1,351	85,766	0	560	87,677
Current liabilities	181,293	472,984	0	527	654,804
Long-term accounts payable	0	7,423	0	0	7,423
Long-term bank loans	57,000	101,963	0	0	158,963

**INTEREST RATE RISK**

The basic objectives of our investment program are to protect the invested funds from excessive risk and to provide for liquidity that is sufficient to meet operating and investment cash requirements. Under the investment policy, our excess cash is invested in high-quality securities which

## Edgar Filing: SOHU COM INC - Form 10-Q

are limited as to length of time to maturity and the amount of credit exposure.

Our exposure to interest rate risk primarily relates to the interest income generated from excess cash invested in demand deposits and debt securities, and interest expense generated from Changyou's loans from offshore banks. We have not used derivative financial instruments in our investment portfolio in order to reduce this risk. We have not been exposed nor do we anticipate being exposed to material risks due to changes in interest rates.

## **Table of Contents**

### **INFLATION RATE RISK**

According to the National Bureau of Statistics of China, the consumer price index grew 2.7 % in the first half of 2013. While this rate of inflation represents a decline compared to the rate for the previous quarter, there may be further increased inflation in the future, which could have a material adverse effect on our business.

### **ITEM 4. CONTROLS AND PROCEDURES**

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report (the Evaluation Date), have concluded that as of the Evaluation Date our disclosure controls and procedures were effective and designed to ensure that all material information relating to Sohu required to be included in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and to ensure that information required to be disclosed is accumulated and communicated to our management, including our principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

During the period covered by this quarterly report, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

There have been no material developments in the legal proceedings reported in our Annual Report on Form 10-K for the year ended December 31, 2012 filed with the SEC on February 28, 2013.

### **ITEM 1A. RISK FACTORS**

There are no material changes or updates to the risk factors previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012 filed with the SEC on February 28, 2013.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

#### *Use of Proceeds*

On July 17, 2000, Sohu completed an underwritten initial public offering of its common stock pursuant to a Registration Statement on Form S-1 (SEC file No. 333-96137), which became effective on July 10, 2000. Public trading of the common stock offered in the initial public offering commenced on July 12, 2000. Sohu sold an aggregate of 4,600,000 shares of common stock in the offering at a price to the public of \$13 per share, resulting in gross proceeds of \$59.8 million. Sohu's net proceeds, after deduction of the underwriting discount of \$4.2 million and other offering expenses of \$3.2 million, were approximately \$52.4 million. All shares sold in the offering were sold by Sohu.

During the six months ended June 30, 2013, Sohu did not use any proceeds from the offering. The remaining net proceeds from the offering have been invested in cash and cash equivalents. The use of the proceeds from the offering does not represent a material change in the use of proceeds described in the prospectus contained in the Registration Statement on Form S-1 described above.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

Please see the Exhibit Index attached hereto.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: August 8, 2013

**SOHU.COM INC.**

By: /s/ Carol Yu  
Carol Yu  
Co-President and Chief Financial Officer



**Table of Contents**

Sohu.com Inc.

Quarterly Report on Form 10-Q for Quarter Ended June 30, 2013

**EXHIBITS INDEX**

- 10.1 Employment Agreement effective as of June 1, 2013, entered into on May 8, 2013, between Sohu.com Inc. and Belinda Wang
- 10.2 Acquisition Framework Agreement, dated as of May 1, 2013, between Changyou.com Webgames (HK) Limited, Burgeon Max Limited, Cadgwith Investments Limited, Double Merits Holdings Limited, Euro Logistics Limited, and 7Road.com Limited.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Charles Zhang
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Carol Yu
- 32.1 Section 1350 Certification of Charles Zhang
- 32.2 Section 1350 Certification of Carol Yu
- 101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Condensed Consolidated Balance Sheets as of June 30, 2013 and December 31, 2012; (ii) Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2013 and 2012; (iii) Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2013 and 2012; (iv) Condensed Consolidated Statements of Changes in Equity for the Six Months Ended June 30, 2013 and 2012; and (v) Notes to Condensed Consolidated Financial Statements, tagged using four different levels of detail.