

SOHU COM INC  
Form 10-Q  
November 07, 2007

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

**FORM 10-Q**  
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES**  
**EXCHANGE ACT OF 1934**

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007**

**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)**

**Delaware**  
**(STATE OR OTHER JURISDICTION OF**  
**INCORPORATION OR ORGANIZATION)**

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

**Level 12, Sohu.com Internet Plaza**

**No. 1 Unit Zhongguancun East Road, Haidian District**

**Beijing 100084**

**People's Republic of China**

**(011) 8610-6272-6666**

**(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  T  
No  F

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

Large accelerated filer  F Accelerated filer  T Non-accelerated filer  F

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

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

| <b>Class</b>                          | <b>Outstanding at September 30, 2007</b> |
|---------------------------------------|--|
| <b>Common stock, \$.001 par value</b> | <b>37,497,553</b>                        |



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**PART I FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****SOHU.COM INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except per share data)**

|   | As of                             |                                |
|---|-----------------------------------|--------------------------------|
|   | September 30, 2007<br>(unaudited) | December 31, 2006<br>(audited) |
| <b>ASSETS</b>   |                                   |                                |
| Current assets:   |                                   |                                |
| Cash and cash equivalents   | \$ 71,902                         | \$ 124,756                     |
| Accounts receivable, net (including \$0 and \$286 from a related party, respectively) | 34,858                            | 23,825                         |
| Prepaid and other current assets  | 8,450                             | 5,961                          |
| Current portion of long-term investments in marketable debt securities                | 4,988                             | 4,942                          |
| Total current assets  | 120,198                           | 159,484                        |
| Investment in an associate  | -                                 | 1,296                          |
| Fixed assets, net   | 61,772                            | 21,453                         |
| Goodwill  | 55,537                            | 54,986                         |
| Intangible assets, net  | 7,475                             | 8,360                          |
| Restricted cash   | 4,281                             | 4,774                          |
| Other assets, net   | 2,584                             | 3,238                          |
|   | \$ 251,847                        | \$ 253,591                     |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                                   |                                |
| Current liabilities:  |                                   |                                |
| Accounts payable  | \$ 2,167                          | \$ 1,177                       |
| Accrued liabilities   | 53,322                            | 36,618                         |
| Current portion of zero coupon convertible senior notes                               | -                                 | 59,780                         |
| Total current liabilities   | 55,489                            | 97,575                         |
| Zero coupon convertible senior notes  | 1,256                             | -                              |
| Total liabilities   | 56,745                            | 97,575                         |
| Commitments and contingencies (Note 9)  |                                   |                                |
| Minority interests  | 12                                | 53                             |
| Shareholders' equity:   |                                   |                                |

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|  |            |            |
|--|------------|------------|
| Common stock: \$0.001 par value per share (75,400 authorized; 37,498 and 36,647 shares issued and outstanding, respectively) | 42         | 41         |
| Additional paid-in capital   | 176,647    | 161,033    |
| Treasury stock (4,137 shares)  | (54,686)   | (54,686)   |
| Accumulated other comprehensive income   | 8,755      | 5,102      |
| Retained earnings  | 64,332     | 44,473     |
| Total shareholders' equity   | 195,090    | 155,963    |
|  | \$ 251,847 | \$ 253,591 |

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

## SOHU.COM INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

(In thousands, except per share data)

|   | Three Months Ended |           | Nine Months Ended |           |
|---|--------------------|-----------|-------------------|-----------|
|   | September 30,      |           | September 30,     |           |
|   | 2007               | 2006      | 2007              | 2006      |
| Revenues:   |                    |           |                   |           |
| Advertising:  |                    |           |                   |           |
| Brand advertising   | \$ 29,781          | \$ 21,024 | \$ 79,940         | \$ 57,003 |
| Sponsored search  | 1,745              | 2,852     | 5,578             | 9,828     |
| Subtotal of advertising revenues  | 31,526             | 23,876    | 85,518            | 66,831    |
| Non-advertising:  |                    |           |                   |           |
| Online game   | 12,693             | 2,214     | 18,135            | 6,421     |
| Wireless  | 6,832              | 8,839     | 18,996            | 25,842    |
| Others  | 467                | 469       | 943               | 792       |
| Subtotal of non-advertising revenues  | 19,992             | 11,522    | 38,074            | 33,055    |
| Total revenues  | 51,518             | 35,398    | 123,592           | 99,886    |
| Cost of revenues:   |                    |           |                   |           |
| Advertising:  |                    |           |                   |           |
| Brand advertising (including share-based compensation expense under SFAS 123(R) of \$382, \$403, \$1,209 and \$1,006, respectively)   | 10,253             | 6,181     | 27,684            | 16,122    |
| Sponsored search (including share-based compensation expense under SFAS 123(R) of \$9, \$24, \$50 and \$68, respectively)             | 1,330              | 1,221     | 4,291             | 3,560     |
| Subtotal of cost of advertising revenues  | 11,583             | 7,402     | 31,975            | 19,682    |
| Non-advertising:  |                    |           |                   |           |
| Online game (including share-based compensation expense under SFAS 123(R) of \$3, \$19, \$34 and \$56, respectively)                  | 2,078              | 1,006     | 4,348             | 3,041     |
| Wireless  | 3,311              | 4,104     | 9,096             | 12,380    |
| Others (including share-based compensation expense under SFAS 123(R) of \$2, \$5, \$10 and \$15, respectively)                        | 178                | 200       | 409               | 425       |
| Subtotal of cost of non-advertising revenues  | 5,567              | 5,310     | 13,853            | 15,846    |
| Total cost of revenues  | 17,150             | 12,712    | 45,828            | 35,528    |
| Gross profit  | 34,368             | 22,686    | 77,764            | 64,358    |
| Operating expenses:   |                    |           |                   |           |
| Product development (including share-based compensation expense under SFAS 123(R) of \$672, \$476, \$2,193 and \$1,301, respectively) | 6,875              | 4,741     | 17,048            | 12,959    |

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|  |          |          |           |           |
|--|----------|----------|-----------|-----------|
| Sales and marketing (including share-based compensation expense under SFAS 123(R) of \$337, \$445, \$1,222 and \$1,191, respectively)        | 13,573   | 7,236    | 30,320    | 20,643    |
| General and administrative (including share-based compensation expense under SFAS 123(R) of \$616, \$563, \$2,183 and \$1,300, respectively) | 4,900    | 4,094    | 11,672    | 10,369    |
| Amortization of intangible assets  | 202      | 509      | 891       | 1,527     |
| Total operating expenses   | 25,550   | 16,580   | 59,931    | 45,498    |
| Operating profit   | 8,818    | 6,106    | 17,833    | 18,860    |
| Other income (expenses)  | 575      | (78)     | 335       | 565       |
| Interest income  | 608      | 951      | 2,434     | 2,267     |
| Income before income tax expense   | 10,001   | 6,979    | 20,602    | 21,692    |
| Income tax expense   | (322)    | (351)    | (767)     | (1,097)   |
| Income from continuing operations  | 9,679    | 6,628    | 19,835    | 20,595    |
| Minority interests   | 12       | -        | 42        | -         |
| Net income from continuing operations  | 9,691    | 6,628    | 19,877    | 20,595    |
| Loss from discontinued e-commerce operations   | (5)      | (27)     | (18)      | (784)     |
| Net income   | \$ 9,686 | \$ 6,601 | \$ 19,859 | \$ 19,811 |
| Basic net income per share (Note 5)  | \$ 0.26  | \$ 0.18  | \$ 0.54   | \$ 0.54   |
| Shares used in computing basic net income per share  | 37,307   | 36,640   | 36,979    | 36,783    |
| Diluted net income per share (Note 5)  | \$ 0.25  | \$ 0.17  | \$ 0.52   | \$ 0.52   |
| Shares used in computing diluted net income per share  | 38,516   | 38,787   | 38,879    | 39,214    |

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

## SOHU.COM INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(In thousands)

|   | <b>Nine Months Ended September 30,</b> |             |
|---|--|-------------|
|   | <b>2007</b>                            | <b>2006</b> |
| Cash flows from operating activities:   |  |             |
| Net income  | \$ 19,859                              | \$ 19,811   |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |             |
| Depreciation  | 7,100                                  | 4,156       |
| Amortization of intangible assets and other assets                                | 2,322                                  | 3,073       |
| Provision for allowance for doubtful accounts                                     | 1,225                                  | 1,145       |
| Share-based compensation expense  | 6,901                                  | 4,937       |
| Excess tax benefits from share-based payment arrangements                         | (155)                                  | -           |
| Gains on early redemption of zero coupon convertible senior notes                 | -                                      | (793)       |
| Others  | 521                                    | 149         |
| Changes in assets and liabilities:  |  |             |
| Accounts receivable   | (10,845)                               | (7,820)     |
| Prepaid and other current assets  | (2,138)                                | (1,798)     |
| Accounts payable  | 989                                    | (268)       |
| Accrued liabilities   | 17,172                                 | (307)       |
| Net cash provided by operating activities   | 42,951                                 | 22,285      |
| Cash flows from investing activities:   |  |             |
| Purchase of fixed assets  | (47,185)                               | (6,724)     |
| Purchase of other assets  | (1,986)                                | (1,050)     |
| Proceeds from disposal of interest in an associate                                | 1,731                                  | -           |
| Decrease (increase) of restricted cash  | 493                                    | (3,750)     |
| Acquisitions, net of cash acquired  | (1,117)                                | (306)       |
| Net cash used in investing activities   | (48,064)                               | (11,830)    |
| Cash flows from financing activities:   |  |             |
| Redemption of zero coupon convertible senior notes                                | (58,524)                               | (14,062)    |
| Repurchase of common stock  | -                                      | (15,000)    |
| Issuance of common stock  | 8,451                                  | 3,688       |
| Excess tax benefits from share-based payment arrangements                         | 155                                    | -           |
| Net cash used in financing activities   | (49,918)                               | (25,374)    |
| Effect of exchange rate change on cash and cash equivalents                       | 2,177                                  | 1,847       |
| Net decrease in cash and cash equivalents   | (52,854)                               | (13,072)    |

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|  |           |    |         |
|--|-----------|----|---------|
| Cash and cash equivalents at beginning of period | 124,756   |    | 119,091 |
| Cash and cash equivalents at end of period       | \$ 71,902 | \$ | 106,019 |

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

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## SOHU.COM INC.

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY (unaudited)

(In thousands)

|  | <b>Nine Months Ended September 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                            | <b>2006</b> |
| Common stock:                                      |  |             |
| Balance, beginning of period                       | \$ 41                                  | \$ 40       |
| Issuance of common stock                           | 1                                      | 1           |
| Balance, end of period                             | 42                                     | 41          |
| Additional paid-in capital:                        |  |             |
| Balance, beginning of period                       | 161,033                                | 148,780     |
| Issuance of common stock                           | 8,450                                  | 3,687       |
| Compensatory share-based awards                    | 6,901                                  | 4,937       |
| Tax benefits from share-based awards               | 263                                    | -           |
| Balance, end of period                             | 176,647                                | 157,404     |
| Treasury stock:                                    |  |             |
| Balance, beginning of period                       | (54,686)                               | (39,686)    |
| Repurchase of common stock                         | -                                      | (15,000)    |
| Balance, end of period                             | (54,686)                               | (54,686)    |
| Accumulated other comprehensive income:            |  |             |
| Balance, beginning of period                       | 5,102                                  | 2,126       |
| Net unrealized gains on marketable debt securities | 46                                     | 123         |
| Foreign currency translation adjustment            | 3,607                                  | 1,809       |
| Balance, end of period                             | 8,755                                  | 4,058       |
| Retained earnings:                                 |  |             |
| Balance, beginning of period                       | 44,473                                 | 18,588      |
| Net income   | 19,859                                 | 19,811      |
| Balance, end of period                             | 64,332                                 | 38,399      |
| Total stockholders' equity                         | \$ 195,090                             | \$ 145,216  |
| Comprehensive income:                              |  |             |
| Net income   | \$ 19,859                              | \$ 19,811   |
| Other comprehensive income:                        |  |             |
| Net unrealized gains on marketable debt securities | 46                                     | 123         |

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|   |    |        |    |        |
|---|----|--------|----|--------|
| Foreign currency translation adjustment |    | 3,607  |    | 1,809  |
| Total comprehensive income              | \$ | 23,512 | \$ | 21,743 |

**Number of Outstanding Shares**

|                              |  |        |  |        |
|------------------------------|--|--------|--|--------|
| Common stock:                |  |        |  |        |
| Balance, beginning of period |  | 36,647 |  | 36,680 |
| Issuance of common stock     |  | 851    |  | 508    |
| Repurchase of common stock   |  | -      |  | (691)  |
| Balance, end of period       |  | 37,498 |  | 36,497 |

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

**SOHU.COM INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. THE COMPANY AND BASIS OF PRESENTATION**

Sohu.com Inc. (the Company or Sohu ) is a leading online media, search, online game and mobile value-added services company providing comprehensive online products and services to consumers and businesses in the People's Republic of China (the PRC or China ). The Company, a Delaware corporation, commenced operations in 1996.

The Company, its subsidiaries and variable interest entities (or VIEs) primarily offer content, brand advertising, sponsored search, online game and wireless services through the Company's Internet sites, www.sohu.com, www.sogou.com, www.chinaren.com, www.17173.com, www.focus.cn, www.goodfeel.com.cn and www.go2map.com. The Company markets its products and services to consumers primarily in the PRC.

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 three and nine months ended September 30, 2007 are not necessarily indicative of the results expected for the full fiscal year or for any future period.

These financial statements have been prepared in accordance with generally accepted accounting principles in the United States 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 generally accepted accounting principles for complete financial statements.

These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

*Accounting Policy on Uncertain Tax Positions*

The Company adopted the Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (or FIN 48), on January 1, 2007. FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This

Interpretation also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. The Company did not have any adjustment to the opening balance of retained earnings as of January 1, 2007 as a result of the implementation of FIN 48.

*Reclassification on Expenses of Online Game Operation*

In quarters prior to April 1, 2007, costs and expenses associated with the Company's online game segment were related to product development and research and an insignificant amount was related to online game operations. Accordingly, the Company had recorded all such costs and expenses in product development expenses in its statements of operations. Beginning April 1, 2007, in order to better present results of operations to enhance comparability with industry peers, the Company decided to reclassify its costs and expenses associated with its online game operations, which mainly consist of salaries and benefits of game masters, from product development expenses to cost of online game revenues. To conform with current period presentations, the relevant amounts for prior periods have been reclassified accordingly. Such reclassification

amounted to \$296,000 for the three months ended September 30, 2006, and \$938,000 for the nine months ended September 30, 2006.

## 2. SEGMENT INFORMATION

Based on the criteria established by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, the Company mainly operates in four principal segments: brand advertising, sponsored search, online game and wireless. In June 2006, the Company terminated its e-commerce business. Accordingly, the results of operations for e-commerce have been reclassified as losses from discontinued operation for all periods presented. From April 1, 2007, the Company adjusted its reportable segments and reclassified the results of its online game segment from its other operations and now reported online game results as a separate segment. Such reclassification amounted to approximately \$2.2 million and \$6.4 million in revenues, \$1.0 million and \$3.0 million in cost of revenues for the three and nine months ended September 30, 2006, respectively.

The Company does not allocate any operating expenses or assets to its brand advertising, sponsored search, online game, wireless and other segments as management does not use this information to measure the performance of the operating segments. Management does not consider share-based compensation for their segment reporting as shown in the tables, as such information does not impact the decisions on resource allocation and segment performance evaluation.

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

|  | <b>Three Months Ended September 30, 2007</b> |                             |                        |                 |               |              |
|--|--|-----------------------------|------------------------|-----------------|---------------|--------------|
|  | <b>Brand<br/>Advertising</b>                 | <b>Sponsored<br/>Search</b> | <b>Online<br/>Game</b> | <b>Wireless</b> | <b>Others</b> | <b>Total</b> |
| Revenues   | \$ 29,781                                    | \$ 1,745                    | \$ 12,693              | \$ 6,832        | \$ 467        | \$ 51,518    |
| Segment cost of revenues                           | (9,871)                                      | (1,321)                     | (2,075)                | (3,311)         | (176)         | (16,754)     |
| Segment gross profit                               | \$ 19,910                                    | \$ 424                      | \$ 10,618              | \$ 3,521        | \$ 291        | \$ 34,764    |
| Share-based compensation expense under SFAS 123(R) |  |                             |                        |                 |               | (396)        |
| Gross profit                                       |  |                             |                        |                 |               | \$ 34,368    |

|          | <b>Three Months Ended September 30, 2006</b> |                             |                        |                 |               |              |
|----------|--|-----------------------------|------------------------|-----------------|---------------|--------------|
|          | <b>Brand<br/>Advertising</b>                 | <b>Sponsored<br/>Search</b> | <b>Online<br/>Game</b> | <b>Wireless</b> | <b>Others</b> | <b>Total</b> |
| Revenues | \$ 21,024                                    | \$ 2,852                    | \$ 2,214               | \$ 8,839        | \$ 469        | \$ 35,398    |

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|  |           |          |          |          |        |           |
|--|-----------|----------|----------|----------|--------|-----------|
| Segment cost of revenues                           | (5,778)   | (1,197)  | (987)    | (4,104)  | (195)  | (12,261)  |
| Segment gross profit                               | \$ 15,246 | \$ 1,655 | \$ 1,227 | \$ 4,735 | \$ 274 | \$ 23,137 |
| Share-based compensation expense under SFAS 123(R) |           |          |          |          |        | (451)     |
| Gross profit                                       |           |          |          |          |        | \$ 22,686 |

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**Nine Months Ended September 30, 2007**

|  | <b>Brand<br/>Advertising</b> | <b>Sponsored<br/>Search</b> | <b>Online<br/>Game</b> | <b>Wireless</b> | <b>Others</b> | <b>Total</b> |
|--|------------------------------|-----------------------------|------------------------|-----------------|---------------|--------------|
| Revenues   | \$ 79,940                    | \$ 5,578                    | \$ 18,135              | \$ 18,996       | \$ 943        | \$ 123,592   |
| Segment cost of revenues                           | (26,475)                     | (4,241)                     | (4,314)                | (9,096)         | (399)         | (44,525)     |
| Segment gross profit                               | \$ 53,465                    | \$ 1,337                    | \$ 13,821              | \$ 9,900        | \$ 544        | \$ 79,067    |
| Share-based compensation expense under SFAS 123(R) |                              |                             |                        |                 |               | (1,303)      |
| Gross profit                                       |                              |                             |                        |                 |               | \$ 77,764    |

**Nine Months Ended September 30, 2006**

|  | <b>Brand<br/>Advertising</b> | <b>Sponsored<br/>Search</b> | <b>Online<br/>Game</b> | <b>Wireless</b> | <b>Others</b> | <b>Total</b> |
|--|------------------------------|-----------------------------|------------------------|-----------------|---------------|--------------|
| Revenues   | \$ 57,003                    | \$ 9,828                    | \$ 6,421               | \$ 25,842       | \$ 792        | \$ 99,886    |
| Segment cost of revenues                           | (15,116)                     | (3,492)                     | (2,985)                | (12,380)        | (410)         | (34,383)     |
| Segment gross profit                               | \$ 41,887                    | \$ 6,336                    | \$ 3,436               | \$ 13,462       | \$ 382        | \$ 65,503    |
| Share-based compensation expense under SFAS 123(R) |                              |                             |                        |                 |               | (1,145)      |
| Gross profit                                       |                              |                             |                        |                 |               | \$ 64,358    |

### 3. OTHER INCOME (EXPENSES)

The following table summarizes the Company's other income (expenses) (in thousands):

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2007</b>                                 | <b>2006</b> | <b>2007</b>                                | <b>2006</b> |
| Gain from disposal of interest in an associate* | \$ 561                                      | \$ -        | \$ 561                                     | \$ -        |
| Gains on early redemption of zero coupon        | -   | -           | -  | 793         |

convertible senior notes \*\*

|   |        |         |        |        |
|---|--------|---------|--------|--------|
| Amortization of offering costs for zero coupon convertible senior notes | -      | (124)   | (248)  | (413)  |
| Share of profits from investment in an associate                        | -      | 44      | 9      | 124    |
| Others  | 14     | 2       | 13     | 61     |
|   | \$ 575 | \$ (78) | \$ 335 | \$ 565 |

\* During the three months ended September 30, 2007, the Company disposed its equity interest in an associated company, which resulted in a gain of \$561,000.

\*\* During the nine months ended September 30, 2006, the Company had early redeemed its zero coupon convertible senior notes with face value of \$15.0 million at a discount, resulting in a gain of \$793,000.

#### 4. INCOME TAX EXPENSE

The Company is subject to taxes in the United States at 34% or 35%, depending upon taxable income levels. Certain of the Company's subsidiaries are subject to taxes in Hong Kong at 17.5% and certain subsidiaries are subject to taxes in China as disclosed below. The Company's subsidiaries in China are governed by the Income Tax Law of the People's Republic of

China concerning Foreign Investment Enterprises and Foreign Enterprises and local income tax laws (the FIE and FE tax law ). Pursuant to the FIE and FE tax law, wholly-owned foreign enterprises are subject to tax at a statutory rate of 33% (30% state income tax plus 3% local income tax), or 15% for certain technology enterprises, on PRC taxable income. Furthermore, new technology enterprises are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction, or a rate of 7.5%, for the subsequent three years and 15% thereafter.

In March 2007, the Chinese government promulgated the Corporate Income Tax Law, which will be effective from January 1, 2008. The Corporate Income Tax Law will impose a unified income tax rate of 25% for both domestic and foreign invested enterprises. The existing tax laws, which stipulated income tax rates for domestic and foreign invested enterprises at different rates, will be abolished simultaneously. Currently, the Company's China-based subsidiaries and VIEs are subject to the tax rates under the existing tax laws. The Corporate Income Tax Law provides for a five-year transitional period for those entities that were subject to FIE and FE tax laws in previous years. The reduced income tax rate for new technology enterprises remains at 15% under the Corporate Income Tax Law. However, the qualifying criteria of a new technology enterprise under the new law and detailed implementation rules have not been released. The Company will continue to assess the impact of such new law in the future.

The Company adopted FIN 48 on January 1, 2007. The Company did not have any adjustment to the opening balance of retained earnings as of January 1, 2007 as a result of the implementation of FIN 48. The Company's policy is to recognize interest and penalties accrued on any uncertain tax positions as a component of income tax expense. During the nine months ended September 30, 2007, the Company did not recognize any interest or penalties associated with any uncertain tax positions.

The Company has not been the subject of income tax audits by any U.S. federal, state or local authorities, or any non-U.S. taxing authorities, for several years.

## **5. 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 and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of shares issuable upon the exercise of share-based awards (using the treasury stock method) and zero coupon convertible senior notes.

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



|   | <b>Three Months Ended September<br/>30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2007</b>                                 | <b>2006</b> | <b>2007</b>                                | <b>2006</b> |
| Numerator:  |   |             |  |             |
| Income from continuing operations                                       | \$ 9,691                                    | \$ 6,628    | \$ 19,877                                  | \$ 20,595   |
| Loss from discontinued e-commerce operations                            | (5)   | (27)        | (18)                                       | (784)       |
| Net income  | 9,686                                       | 6,601       | 19,859                                     | 19,811      |
| Effect of dilutive securities:  |   |             |  |             |
| Amortization of offering costs for zero coupon convertible senior notes | -   | 124         | 248  | 413         |
| Net income adjusted for dilutive securities                             | \$ 9,686                                    | \$ 6,725    | \$ 20,107                                  | \$ 20,224   |
| Denominator:  |   |             |  |             |
| Weighted average basic common shares outstanding                        | 37,307                                      | 36,640      | 36,979                                     | 36,783      |
| Effect of dilutive securities:  |   |             |  |             |
| Stock options and restricted stock units                                | 1,181                                       | 811         | 1,038                                      | 946         |
| Zero coupon convertible senior notes                                    | 28  | 1,336       | 862  | 1,485       |
| Weighted average diluted common shares outstanding                      | 38,516                                      | 38,787      | 38,879                                     | 39,214      |
| Basic income per share from continuing operations                       |   |             |  |             |
|   | \$ 0.26                                     | \$ 0.18     | \$ 0.54                                    | \$ 0.56     |
| Basic loss per share from discontinued e-commerce operations            |   |             |  |             |
|   | -   | -           | -  | (0.02)      |
| Basic net income per share  |   |             |  |             |
|   | \$ 0.26                                     | \$ 0.18     | \$ 0.54                                    | \$ 0.54     |
| Diluted income per share from continuing operations                     |   |             |  |             |
|   | \$ 0.25                                     | \$ 0.17     | \$ 0.52                                    | \$ 0.54     |
| Diluted loss per share from discontinued e-commerce operations          |   |             |  |             |
|   | -   | -           | -  | (0.02)      |
| Diluted net income per share  |   |             |  |             |
|   | \$ 0.25                                     | \$ 0.17     | \$ 0.52                                    | \$ 0.52     |

## 6. SHARE-BASED COMPENSATION EXPENSE

The Company's 2000 Stock Incentive Plan, including stock options and restricted stock units, provides for the issuance of up to 9,500,000 shares of common stock. The maximum term of any issued stock right is ten years from the grant date.

The Company has reserved 9,500,000 shares of new common stock for issuance under the Company's 2000 Stock Incentive Plan. As of September 30, 2007, 1,048,984 shares were available for grant under the plan.

A summary of option activity under the Company's 2000 Stock Incentive Plan as of September 30, 2007, and changes during the nine month period then ended, is presented below:

| <b>Options</b>   | <b>Number<br/>of<br/>Shares<br/>(in<br/>thousands)</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life (Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in thousands)</b> |
|--|--|--|--|---|
| Outstanding at January 1, 2007                               | 2,580  | \$ 15.69   | 7.15   | \$ 23,206   |
| Exercised  | (755)  | 11.20  |  |   |
| Forfeited or expired   | (151)  | 19.25  |  |   |
| Outstanding at September 30, 2007                            | 1,674  | 17.40  | 6.74   | \$ 34,002   |
| Vested at September 30, 2007 and expected to vest thereafter | 1,552  | 17.33  | 6.68   | \$ 31,630   |
| Exercisable at September 30, 2007                            | 1,199  | 17.13  | 6.44   | \$ 24,685   |

The aggregate intrinsic value in the preceding table represents the total intrinsic value based on the Company's closing stock price of \$37.71 as of September 28, 2007.

The total intrinsic value of options exercised during the nine month period ended September 30, 2007 was \$13.7 million.

A summary of restricted stock unit activity under the Company's 2000 Stock Incentive Plan as of September 30, 2007, and changes during the nine month period then ended, is presented below:

| <b>Restricted Stock Units</b>  | <b>Number of<br/>Shares<br/>(in thousands)</b> | <b>Weighted-Average<br/>Grant-Date<br/>Fair Value</b> |
|--------------------------------|--|---|
| Unvested at January 1, 2007    | 529  | \$ 24.03  |
| Granted                        | 251  | 25.39   |
| Vested                         | (115)  | 23.54   |
| Forfeited                      | (63)   | 24.50   |
| Unvested at September 30, 2007 | 602  | 24.64   |
| Expected to vest thereafter    | 453  | 24.59   |

As of September 30, 2007, there was \$1.8 million of total unrecognized compensation cost related to options for which services had not been provided, net of forecasted forfeitures. Such cost is expected to be recognized over a weighted average period of 0.8 year. Total fair value of options expensed during the three months ended September 30, 2007 and 2006 was \$0.6 million and \$1.1 million, respectively.

As of September 30, 2007, there was \$7.1 million of total unrecognized compensation cost related to unvested restricted stock units, net of forecasted forfeitures. Such cost is expected to be recognized over a weighted average period of 1.2 years. Total fair value of restricted stock units expensed during the three months ended September 30, 2007 and 2006 was \$1.4 million and \$0.8 million, respectively.

There were no capitalized share-based compensation costs during the three and nine months ended September 30, 2007 and 2006.

During the three months ended September 30, 2007 and 2006, total cash received from the exercise of stock options

amounted to \$4.3 million and \$1.3 million, respectively.

## 7. VIEs

FIN 46R Consolidation of Variable Interest Entities requires a VIE to be consolidated by a company if that company is the primary beneficiary of that VIE.

To satisfy PRC laws and regulations, the Company conducts its Internet information, wireless and certain other businesses in the PRC via its VIEs. These VIEs are directly or indirectly owned by Dr. Charles Zhang (or Dr. Zhang), the Company's Chairman, Chief Executive Officer and a major shareholder, and certain employees of the Company. Capital for the VIEs is funded by the Company through loans provided to Dr. Zhang and those employees, and is initially recorded as loans to related parties. These loans are eliminated for accounting purposes with the capital of VIEs during consolidation.

Under contractual agreements with the Company, Dr. Zhang and other Sohu employees who are shareholders of the VIEs are required to transfer their ownership in these entities to the Company, if permitted by PRC laws and regulations, or, if not so permitted, to designees of the Company at any time to repay the loans outstanding. All voting rights of the VIEs are assigned to the Company, and the Company has the right to designate all directors and senior management personnel of the VIEs. Dr. Zhang and the other Sohu employees who are shareholders of the VIEs have pledged their shares in the VIEs as collateral for the loans. As of September 30, 2007, the aggregated amount of these loans was \$11.2 million.

The following is a summary of the VIEs of the Company:

a)

#### High Century

Beijing Century High Tech Investment Co., Ltd. (or High Century) was incorporated in the PRC in 2001 and engages in investment holding in the PRC on behalf of the Company. The registered capital of High Century is \$4,595,000. Dr. Zhang and Li Wei, an employee of the Company, hold 80% and 20% interests in High Century, respectively.

b)

#### Sohu Entertainment

Beijing Sohu Entertainment Culture Media Co., Ltd. (or Sohu Entertainment), formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd (or Hengda) was incorporated in the PRC in 2002 and engages in Internet access and wireless services in the PRC on behalf of the Company. The registered capital of Sohu Entertainment is \$1,210,000. Originally, High Century and Li Wei held 80% and 20% interests in Sohu Entertainment, respectively. In November 2004, to further satisfy PRC regulations, High Century and Li Wei transferred their interests in Sohu Entertainment to Xin Wang (Belinda) and Wang Jianjun, each of whom was an employee of the Company. In July 2007, Wang Jianjun transferred all his interests in Sohu Entertainment to Deng Ye, an employee of the Company. As a result, Xin Wang (Belinda) and Deng Ye own 80% and 20% interests in Sohu Entertainment, respectively.

c)

#### Sohu Internet

Beijing Sohu Internet Information Service Co. Ltd. (or Sohu Internet) was incorporated in the PRC in 2003 and engages in Internet information, wireless and advertising services in the PRC on behalf of the Company. The original registered capital was \$605,000, and High Century and He Jinmei held 80% and 20% interests in Sohu Internet, respectively. In December 2003, Sohu Entertainment made a \$605,000 investment in Sohu Internet. In April 2005, He Jinmei transferred all her interests in Sohu Internet to High Century, and High Century made a \$1,208,000 additional investment in Sohu Internet. As a result, the registered capital is now \$2,418,000, with High Century and Sohu Entertainment holding 75% and 25% interests, respectively.

d)

Goodfeel

Beijing Goodfeel Information Technology Co., Ltd. (or Goodfeel) was incorporated in the PRC in 2001 and engages in value-added telecommunication services in the PRC. The registered capital of Goodfeel is \$1,208,000. In May 2004, High Century and Sohu Internet acquired 73% and 27% interests in Goodfeel, respectively. In July 2004, High Century and Sohu Internet invested \$613,000 and \$473,000 in Goodfeel, respectively, so that High Century owned a 58.1% interest in Goodfeel with the remaining 41.9% interest owned by Sohu Internet. In October 2004, to further satisfy PRC regulations, High Century and Sohu Internet transferred their interests in Goodfeel to Deng Xiufeng and Zhou Jing, each of whom is an employee of the

Company. In August 2007, Deng Xiufeng transferred all his interests in Goodfeel to Yue Guofeng, an employee of the Company. As a result, Yue Guofeng and Zhou Jing own 58.1% and 41.9% interests in Goodfeel, respectively.

e)

Huohu

Beijing Huohu Digital Technology Co., Ltd. (or Huohu) was incorporated in the PRC in 2005. Huohu engages in software and technology development for the online game business. The registered capital of Huohu is \$121,000. Sohu Internet and an employee of Huohu hold 75% and 25% interests in Huohu, respectively. The Company provided the employee with a non-interest bearing loan of \$33,000 to finance his capital contribution to Huohu. The loan is repayable upon demand by the Company at any time or upon termination of the employment of the employee and can only be repaid through transfer of the employee's shares in Huohu to Sohu Internet. Based on the arrangement between Sohu Internet and the employee, Sohu Internet is the sole and primary beneficiary of Huohu.

f)

Tu Xing Tian Xia

Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (or Tu Xing Tian Xia) was incorporated in the PRC in 1999 and engages in mapping services in the PRC. The registered capital of Tu Xing Tian Xia is \$248,000. In May 2005, in connection with the Company's acquisition of Go2Map, the Company designated High Century and Sohu Internet as its designees to purchase the outstanding registered capital of Tu Xing Tian Xia. As a result, High Century and Sohu Internet own 56.1% and 43.9% interests in Tu Xing Tian Xia, respectively.

g)

Feng Yang Tian Lang

Beijing Feng Yang Tian Lang Advertising Co., Ltd. (or Feng Yang Tian Lang) was incorporated in the PRC in 2005 and engages in advertising services in the PRC. The registered capital of Feng Yang Tian Lang is \$248,000. Sohu Internet and High Century each holds a 50% interest in Feng Yang Tian Lang.

h)

Sogou Information

Beijing Sogou Information Services Co., Ltd. (or Sogou Information) was incorporated in the PRC in 2005 and engages in providing Internet information services in the PRC. The registered capital of Sogou Information is \$2,480,000. Zhou Jing and Li Wei, each of whom is an employee of the Company, each owns a 50% interest in Sogou Information.

i)

Guangzhou Interactive

Guangzhou Sohu Interactive Network Technology Co., Ltd (or Guangzhou Interactive) was incorporated in the PRC in 2006 and engages in providing Internet information services in Guangdong Province. The registered capital of Guangzhou Interactive is \$631,000. Sohu Internet and High Century each holds a 50% interest in Guangzhou Interactive.

j)

Gamease Age

Beijing Gamease Age Digital Technology Co., Ltd. (or Gamease Age) was incorporated in the PRC in August 2007 and engages in Internet information services. The registered capital of Gamease Age is \$1,331,000. Wang

Tao and Zhou Jing, each of whom is an employee of the Company, each owns 60% and 40% interest in Gamease Age.

Pursuant to FIN 46R, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang, Sogou Information, Guangzhou Interactive and Gamease Age are VIEs, of which the Company is the primary beneficiary. Accordingly, the VIEs have been consolidated in the Company's financial statements. As of September 30, 2007, the above VIEs have aggregate accumulated net profits of approximately \$4.3 million which have been reflected in the consolidated financial statements.

## 8. RELATED PARTY TRANSACTIONS

The following table summarizes related party transactions during the three and nine months ended September 30, 2007 and 2006, respectively (in thousands):

| Name or<br>Description of<br>Related Party          | Description of<br>Transactions       | Accounting<br>Captions       | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|--------------------------------------|------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|   |                                      |                              | September 30,<br>2007 | September 30,<br>2006 | September 30,<br>2007 | September 30,<br>2006 |
| Qingfan, a company controlled by Dr Zhang's brother | Delivery service provided by Qingfan | Cost of revenues             | \$ -                  | \$ -                  | \$ -                  | \$ 27                 |
| An investee of the Company*                         | Amortization of licensing fee        | Product development expenses | -                     | 17                    | -                     | 69                    |
|   | Revenue sharing                      | Cost of revenues             | 206                   | 480                   | 949                   | 1,361                 |

\* This investee ceased to be a related party of the Company starting September 1, 2007, when the Company disposed its equity investment. Accordingly, since then, transactions with this party are not regarded as related party transactions.

## 9. COMMITMENTS AND CONTINGENCIES

The Company's China-based subsidiaries and VIEs, Sohu Era, Sohu Internet, Sogou Information, Beijing Sogou Technology Development Co., Ltd. (or Sogou Technology) and Beijing Sohu New Media Information Technology Co., Ltd. (or Sohu Media) enjoy tax benefits which are available to new technology enterprises. The effective income tax rate for new technology enterprises registered and operating in Beijing Zhongguancun Science Park is 15%, while the local income tax will be exempted as long as the enterprise holds the status of a new technology enterprise. New technology enterprises are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction, at the rate of 7.5%, for the subsequent three years.

Sohu Era and Sohu Internet were incorporated in 2003 and, providing there is no change in their status as a new technology enterprise or a change in the relevant regulations, are subject to an income tax rate of 0% in 2003 to 2005, 7.5% in 2006 to 2008 and 15% thereafter. Sogou Information was incorporated in 2005, Sogou Technology and Sohu Media were incorporated in 2006 and, providing there is no change in their status as a new technology enterprise or a change in the relevant regulations, are subject to an income tax rate of 0% in 2006 to 2008, 7.5% in 2009 to 2011 and 15% thereafter. To be considered a new technology enterprise under current PRC law, a company must: (i) operate in the high-tech industry (which includes the information technology industry); (ii) be incorporated and operate in Beijing Zhongguancun Science Park; (iii) receive 60% of its revenue from high-tech products or services; and (iv) have at least 20% of its employees involved in technology development. New technology enterprises are subject to annual inspection to determine whether they continue to meet these requirements. If Sohu Era, Sohu Internet, Sogou Information, Sogou Technology and Sohu Media did not meet the requirements of a new technology enterprise, they could be subject to enterprise income tax in China at rates up to 33%, which could cause a significant reduction in the Company's after-tax income.

In March 2007, the Chinese government promulgated the Corporate Income Tax Law which will be effective from January 1, 2008. The Corporate Income Tax Law will impose a unified income tax rate of 25% for both domestic and foreign invested enterprise. The existing tax laws, which stipulated income tax rates for domestic and foreign invested enterprises at different rates, will be abolished simultaneously. Currently, the Company's China-based subsidiaries and VIEs are subject to the tax rates under the existing tax laws. The Corporate Income Tax Law provides for a five-year transitional period for those entities that were subject to FIE and FE tax laws in previous years. The reduced income tax rate for new technology enterprises remains at 15% under the Corporate Income Tax Law. However, the qualifying criteria of a new technology enterprise under the new law and detailed implementation rules have not been released. The Company will continue to assess the impact of such new law in the future. If any of Sohu Era, Sohu Internet, Sogou Information, Sogou Technology or Sohu Media does not meet the requirements of a new technology enterprise under the new Corporate Income Tax Law, its tax rate will eventually become 25%.

The Chinese market in which the Company operates poses certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability of the Company to operate an Internet business, and to conduct brand advertising, sponsored search, online game and wireless 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 Company, may operate. The Chinese government may issue from time to time new laws or new interpretations on existing laws to regulate areas such as telecommunication, information and media. Regulatory risks also encompass the interpretation by the tax authorities of current tax laws and regulations, including the applicability of certain preferential tax treatments. The Company's legal structure and scope of operations in China could be subjected to restrictions which could result in severe limits to the Company's ability to conduct business in the PRC.

The Company's sales, purchase and expense transactions are generally denominated in RMB and a significant portion of the Company's 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 the Company's subsidiaries in China may require certain supporting documentation in order to effect the remittance.

From time to time, the Company becomes subject to legal proceedings and claims in the ordinary course of our business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights in connection with the content published on our Websites. The Company provides for the amount of loss, if there is information available prior to issuance of the Company's financial statements indicating that it is probable that a liability had been incurred at the date of the financial statements and the amount of loss can be reasonably estimated.

The Company had entered in certain sponsorship agreements, under which the Company is obliged to provide advertising services and Website construction, operation and maintenance services to third parties during the contract periods.

As of September 30, 2007, the Company had future minimum content and service purchase commitments of \$15.9 million, \$3.1 million and \$0.2 million for the years ending September 30, 2008, 2009 and 2010, respectively. As of September 30, 2007, the Company had made certain deposits into restricted bank accounts as guarantees to meet the requirements under those contracts.

**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, Sohu and Sohu.com are to Sohu.com Inc. and, except where the context requires otherwise, our subsidiaries, Sohu.com (Hong Kong) Limited (or Sohu Hong Kong), Sohu.com Limited, Kylie Enterprises Limited, All Honest International Limited, Marvel Hero Limited, Go2Map Inc., Sohu.com (Search) Limited, Sogou Inc., Sogou (BVI) Limited, 21 East Entertainment Limited (or 21 East HK), TL Age Limited, TL Age Hong Kong Limited, Beijing Sohu New Era Information Technology Co., Ltd. (or Sohu Era), Beijing Sohu Interactive Software Co., Ltd. (or Sohu Software), Go2Map Software (Beijing) Co., Ltd. (or Go2Map Software), Beijing Sogou Technology Development Co., Ltd. (or Sogou Technology), Beijing Sohu New Media Information Technology Co., Ltd. (or Sohu Media) and Beijing AmazGame Internet Technology Co., Ltd. (or AmazGame Age), and our VIEs Beijing Century High Tech Investment Co., Ltd. (or High Century), Beijing Sohu Entertainment Culture Media Co., Ltd. (or Sohu Entertainment, formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd. (or Hengda)), Beijing Sohu Internet Information Service Co., Ltd. (or Sohu Internet), Beijing Goodfeel Information Technology Co., Ltd. (or Goodfeel), Beijing Huohu Digital Technology Co., Ltd. (or Huohu), Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (or Tu Xing Tian Xia), Beijing Feng Yang Tian Lang Advertising Co., Ltd (or Feng Yang Tian Lang), Beijing Sogou Information Services Co., Ltd. (or Sogou Information), Guangzhou Sohu Interactive Network Technology Co., Ltd. (or Guangzhou Interactive), Beijing 21 East Culture Development Co., Ltd (or 21 East Beijing) and Beijing Gamease Age Digital Technology Co., Ltd. (or Gamease Age), 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, 2006 filed with the SEC on March 8, 2007 and in Part I, Item 2 of our Quarterly Report on Form 10-Q for the three months ended June 30, 2007 filed with the SEC on August 6, 2007, as updated by Part II Item 1A of this report. Readers are cautioned not to place undue reliance on these forward-looking statements.*

**OVERVIEW**

We are a leading online media, search, online game and mobile value-added services company providing comprehensive online products and services to consumers and businesses in China, through our comprehensive matrices of web properties, consisting of the mass portal and leading online media destination [www.sohu.com](http://www.sohu.com); the interactive search engine [www.sogou.com](http://www.sogou.com); the leading online alumni club [www.chinaren.com](http://www.chinaren.com); the leading games information portal [www.17173.com](http://www.17173.com); one of the top real estate Websites [www.focus.cn](http://www.focus.cn); the wireless value-added

services provider [www.goodfeel.com.cn](http://www.goodfeel.com.cn); and a leading online mapping service Website [www.go2map.com](http://www.go2map.com). We offer our user community very broad choices regarding information, entertainment, communication, online game and wireless services. We derive revenue primarily through the sale of brand advertising, sponsored search, online game and wireless services. We also sponsor major events to further enhance our viewership and create a positive branding impact.

We were incorporated in the state of Delaware in August 1996 as Internet Technologies China Incorporated, and launched our original Website, itc.com.cn, in January 1997. During 1997, we developed the Sohu online directory, search engine and related technology infrastructure, and also focused on recruiting personnel, raising capital and aggregating content to attract and retain users. In February 1998, we re-launched our Website under the domain name sohu.com. In September 1999, we re-named our company Sohu.com Inc. Our business operations are conducted primarily through our indirect wholly owned subsidiaries, Sohu Era, Sohu Software, Go2Map Software, Sogou Technology, Sohu Media and AmazGame Age and our VIEs, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang, Sogou Information, Guangzhou Interactive, Gamease Age and 21 East Beijing.

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

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. 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. We believe accounting for brand advertising and sponsored search revenues, accounting for online game revenues, accounting for wireless revenues and cost of revenues, gross versus net basis of revenue recognition, determination of functional currencies, allowance for doubtful accounts, assessment of impairment for goodwill, intangible assets, fixed assets and other assets, determination of share-based compensation expense, and assessment of current income tax position and valuation allowance against deferred tax assets, represent critical accounting policies that reflect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

### ***Revenue Recognition***

#### **Advertising Revenues**

Advertising revenues include revenue from brand advertising and sponsored search services, after deducting agent rebates and applicable business tax. No revenues from advertising-for-advertising barter transactions were recognized.

Brand advertising contracts establish the fixed price and advertising services to be provided. Pursuant to brand advertising contracts, we provide advertisement placements on various Website channels and in different formats, including but not limited to banners, links, logos, buttons, rich media and content integration. Revenue is recognized ratably over the period the advertising is provided and, as such, we consider the services to have been delivered. We treat all elements of advertising contracts as a single unit of accounting for revenue recognition purposes. Based upon

our credit assessments of our customers prior to entering into contracts, we determine if collectibility is reasonably assured. In situations where collectibility is not deemed to be reasonably assured, we recognize revenue upon payment from the customer.

Sponsorship contracts may include services similar to those in our brand advertising contracts, are generally for larger dollar amounts and for a longer period of time, may allow advertisers to sponsor a particular area on our Websites, may include brand affiliation services and/or a larger volume of services, and may require some exclusivity or premiere placements. Sponsorship advertisement revenues are normally recognized on a straight-line basis over the contract period, provided we are meeting our obligations under the contract.

Pursuant to sponsored search contracts, which are normally for relatively small dollar amounts and are with small and medium sized enterprises, sponsored search services mainly include priority placements in our search directory and pay-for-click services consisting of displaying the text-based links of our advertisers on our Websites and our Website Alliance network. We normally provide priority placements services for a fixed fee over the service period of the contracts. Revenues on priority placements are normally recognized on a straight-line basis over the contract period provided we are meeting our obligation under the contract. Pay-for-click services of displaying the text-based links to our advertisers Websites are charged on a cost per click basis, so that an advertiser pays us only when a user clicks on the displayed link. The priority of the display of text-based links is based on the bidding price of different advertisers. Revenues from the pay-for-click services are recognized as the users click on the links.

Material differences could result in the amount and timing of our advertising revenue for any period if management made different judgments or utilized different estimates.

### Non-Advertising Revenues

Non-advertising revenues include revenues principally from online game and wireless services.

Online game revenues are collected through sale of our prepaid cards, which we sell in both virtual and physical form, to third party distributors and retailers. Prior to December 2006, we operated our Massive Multiplayer Online Role Playing Games (or MMORPGs) under a time-based model. Under this model, the proceeds from sale of prepaid cards from distributors or retailers are deferred when received and revenue is recognized based upon the actual usage of time units by the end users. In December 2006, we changed the revenue model from time-based to item-based. Under the new item-based model, players play a game on a free of charge basis and with the ability to purchase in-game premium features. Proceeds from sale of prepaid cards are deferred when received and revenue is recognized over the estimated lives of the premium features purchased or as the premium features are consumed. While we have adopted the new item-based model for our online games for a relatively short operation history, we considered the average period that players typically play our games and other player behavior patterns to arrive at our best estimates for the lives of these in-game features.

Wireless revenues are derived from providing short messaging services (or SMS), Ring Back Tone (or RBT), Wireless Application Protocol (or WAP), multi-media messaging services (or MMS), and interactive voice response (or IVR), mainly consisting of news, weather forecast, chatting, entertainment information, ring tones and logo downloads and various other mobile related products provided to mobile phone users. Wireless service fees are charged on a monthly or per message/download basis. Wireless revenues and cost of revenues are recognized in the month in which the service is performed, provided no significant Sohu obligations remain. We rely on mobile network operators in China to bill mobile phone users for wireless service fees. In order to meet ownership requirements under PRC law which restrict or prohibit wholly foreign owned enterprises from providing Internet information and value-added telecommunication services such as wireless, we rely on Sohu Internet and Goodfeel to contract with the mobile network operators. Generally, (i) within 15 to 120 days after the end of each month, Sohu Internet or Goodfeel receives statements from each of the operators confirming the amount of wireless service charges billed to that operator's mobile phone users and (ii) within 30 to 180 days after delivering monthly statements, each operator remits

the wireless service fees, net of its service fees, for the month to Sohu Internet or Goodfeel. In order to recognize revenue and be paid for services provided, we rely on billing confirmations from the mobile network operators as to the actual amount of services they have billed to their mobile customers. We are unable to collect certain wireless services fees from an operator in certain circumstances due to technical issues with the operator's network. This is referred to as the failure rate, which can vary from operator to operator. Recently, the time lag in receiving monthly statements from one of the mobile network operators has increased. At the end of each reporting period, where an operator has not provided Sohu Internet or Goodfeel with the monthly statements for any month confirming the amount of wireless service charges billed to that operator's mobile phone users for the month, Sohu, using information generated from

its own internal system and historical data, makes estimates of the failure rate and collectable wireless service fees and accrues revenue accordingly. The quarterly historical differences in our estimated revenue which was recorded in the financial statements compared to the actual revenue have ranged from an underestimation of \$538,000 (gross margin underestimate of \$286,000) to an overestimation of \$340,000 (gross margin overestimate of \$171,000) since 2002 when wireless revenues began representing a significant portion of our total revenues. We believe we have the ability to make a reasonable estimate. However, differences between the actual failure rate and bad debt rate per an operator's statement and our internal estimates could result in material differences in the amount and timing of our revenue and cost of non-advertising revenue for any period. For the three months ended September 30, 2007, 65% of our estimated wireless revenues were confirmed by the monthly statements received from the mobile network operators.

Our management must determine whether to record our wireless revenues using the gross or net method of reporting. Determining whether revenue should be reported gross or net is based on an assessment of various factors, principally whether Sohu is acting as the principal in offering services to the customer or whether Sohu is acting as an agent in the transaction. To the extent Sohu is acting as a principal in a transaction, Sohu reports as revenue the payments received on a gross basis, and reports as costs of revenue the amounts attributable to services provided by mobile network operators and other vendors. To the extent Sohu is acting as an agent in a transaction, Sohu reports on a net basis reporting as revenue the payments received less commission and other payments to third parties. The determination of whether Sohu is serving as principal or agent in a transaction is judgmental in nature and based on an evaluation of the terms of an arrangement.

Based on our assessment, the majority of our wireless revenues are recorded on a gross basis. We have primary responsibility for fulfillment and acceptability of the wireless services. The content and nature of the wireless services are designed and developed by us (either independently or with third parties) and originate from our Websites, our links located on third parties' Websites, or one of our dedicated phone numbers. The mobile network operators that we contract with to deliver these services to the end customers are not involved in the design or development of the services that are provided by us. The end customer purchases the wireless content, community access or value-added services, such as news, weather forecast, chatting, entertainment information, music, ring tone, picture and logo downloads that Sohu provides. The end customer receives identical services from us regardless of which mobile network operator is used to deliver the message. In addition, we provide customer services to the end customers directly and we could be requested by the mobile network operators to assume the credit risk if the operators are not able to collect fees from the end customers. Sohu has determined that in addition to the indicators of gross reporting, there are also certain indicators of net reporting, including the fact that the mobile network operators set maximum prices that Sohu can charge and that the mobile network operators also have the right to set requirements and procedures associated with using their platform. However, Sohu has determined that the gross revenue reporting indicators are stronger, because Sohu is the primary obligor, adds value to the products, has inventory risk related to content and products, and has reasonable pricing latitude.

To the extent revenues are recorded gross, any commissions or other payments to third parties are recorded as costs or expenses so that the net amount (gross revenues, less costs and expenses) flows through to operating income. Accordingly, the impact on operating income is the same whether Sohu records the revenue on a gross or net basis.

### ***Functional Currency***

Our functional currency is the US Dollar. The functional currency of our subsidiaries and VIEs in China is RMB. 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 it primarily generates and expends cash. Management's judgment is essential in determination of the functional currency by assessing various indicators, such as cash flow, sales price and market, expenses, financing and inter-company transactions and arrangements. Assets and liabilities of the China subsidiaries and VIEs are translated into US Dollars, our reporting currency, at the exchange rate in effect at the balance sheet date. Foreign currency translation

adjustments are not included in determining net income for the period but are accumulated in a separate component of consolidated equity on the balance sheet. The accumulated foreign currency translation adjustment as of September 30, 2007 and December 31, 2006 was a gain of \$8.8 million and \$5.2 million, respectively.

### *Allowance for Doubtful Accounts Receivables*

Our management must make estimates of the collectibility of our accounts receivables. Management specifically analyzes accounts receivables, historical bad debts, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our accounts receivable balance was \$36.6 million, net of allowance for doubtful accounts of \$1.7 million as of September 30, 2007. If the financial condition of Sohu's customers or mobile network operators were to deteriorate, resulting in their inability to make payments, or the mobile network operators requested that we assume additional bad debts as a result of the operators' inability to collect fees from end customers, additional allowance might be required.

### *Impairment on Long-Lived Assets*

Our long-lived assets include goodwill, intangible assets, fixed assets and other assets. We test goodwill for impairment at the reporting unit level (operating segment) on an annual basis, and between annual tests when an event occurs or circumstances change that could more likely than not reduce the fair value of goodwill below its carrying value. Application of a goodwill impairment test requires 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. Significant judgments required to estimate the fair value of reporting units include 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. Any impairment losses recorded in the future could have a material adverse impact on our financial condition and results of operations. As of September 30, 2007, we did not believe that any event or change of circumstances had occurred that would result in material impairment losses in goodwill.

In respect of our intangible assets, which mainly comprise domain names, trademarks, customer lists and computer software purchased from unrelated third parties, we amortize the costs over their expected future economic lives. Fixed assets comprise building, computer equipment, office furniture and equipment, vehicles and leasehold improvement, and are depreciated over the estimated useful lives of the assets on a straight-line basis. Other assets mainly include prepaid content fees and rental deposits. We amortize the content fees over the terms of the contracts. Management's judgment is required in the assessment of the economic lives of intangible assets and useful lives of the fixed assets and other assets. Based on the existence of one or more indicators of impairment, we measure any impairment of intangible assets, fixed assets and other assets based on a projected discounted cash flow method using a discount rate determined by our management which is commensurate with the risk inherent in our business model. An impairment charge would be recorded if we determined that the carrying value of intangible assets, fixed assets or other assets may not be recoverable. Our estimates of future cash flows require significant judgment based on our historical results and anticipated results and are subject to many factors. As of September 30, 2007, we were not aware of any indication of impairment of our intangible assets, fixed assets and other assets.

*Share-Based Compensation*

Effective from January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (or SFAS 123(R)), which requires all share-based payments to employees and directors, including grants of stock options and restricted stock units, to be recognized in the financial statements based on their grant date fair values.

As of January 1, 2006, we adopted SFAS 123(R) using the modified prospective method. The fair value of the options granted before January 1, 2006 is determined based on the Black-Scholes valuation model, which is consistent with the valuation techniques utilized when we prepared pro forma information under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (or SFAS 123). Restricted stock units are measured based on the fair market values of the underlying stock on the dates of grant. Fair value of the share-based awards is recognized as share-based compensation cost over the requisite service period, net of estimated forfeitures on an accelerated basis under SFAS 123(R).

The determination of the fair value of share-based awards and related share-based compensation expense requires input of subjective assumptions, including but not limited to the valuation model adopted, risk-free interest rates, expected life of the share-based awards, stock price volatility, and expected forfeiture rate. The selection of an appropriate valuation technique or model depends on the substantive characteristics of the instrument being valued. Risk-free interest rates are decided based on the yield to maturity of US government bonds as at respective dates of grant of options. Expected life is the number of years that we estimate, based primarily on the history, using plain-vanilla method, that options will be outstanding prior to settlement. Volatility is measured using historical daily price changes of our stock over the respective expected life of the option. Forfeiture rate is estimated based on historical forfeiture pattern and adjusted in accordance with our expectation for the future.

Our input assumptions were based on historical experience, with consideration to developing expectations about the future. The assumptions used in calculating the fair value of share-based awards and related share-based compensation represent management's best estimations, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change or we utilize different assumptions, our share-based compensation expense could be materially different for any period.

#### ***Current Income Tax Position and Valuation Allowance against Deferred Tax Assets***

We estimate income tax expense in each of the jurisdictions in which we operate for each period presented, including estimating current tax exposure as well as assessing realizable deferred tax assets and deferred tax liabilities.

As of September 30, 2007, the majority of our deferred tax assets are related to net operating losses that would apply to United States income taxes. As substantially all of our income is earned in China, and we do not intend in the foreseeable future to repatriate this income to the United States where it would be taxable, it is more likely than not that deferred tax assets resulting from these net operating losses will not be realized. The remaining deferred tax assets are related to China-based subsidiaries and VIEs, resulting from net operating losses and temporary differences between accounting and tax bases. We believe that it is more likely than not that the balance will not be realized. We have recorded a valuation allowance against our gross deferred tax assets in order to reduce our deferred tax assets to the amount that is more likely than not to be realized. 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.

## RESULTS OF OPERATIONS

### FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006

In order to focus on our core revenue source of online advertising, on June 20, 2006 we discontinued our unprofitable e-commerce business. As a result of the discontinuation of this business, the e-commerce business is accounted for as a discontinued operation. Accordingly, our statements of operations separate the discontinued operation for all periods presented.

## REVENUES

Total revenues were \$51.5 million and \$123.6 million for the three and nine months ended September 30, 2007, respectively, as compared to \$35.4 million and \$99.9 million for the corresponding periods in 2006.

### Advertising Revenues

Advertising revenues are derived principally from brand advertising and sponsored search.

Advertising revenues were \$31.5 million and \$85.5 million, or 61% and 69% of total revenues, for the three and nine months ended September 30, 2007, as compared to \$23.9 million and \$66.8 million, or 67% of total revenues for both the corresponding periods in 2006. For the three and nine months ended September 30, 2007, advertising revenues consisted of revenues from brand advertising of \$29.8 million and \$79.9 million, and revenues from sponsored search of \$1.7 million and \$5.6 million. For the three and nine months ended September 30, 2006, advertising revenues consisted of revenues from brand advertising of \$21.0 million and \$57.0 million, and revenues from sponsored search of \$2.9 million and \$9.8 million.

*Brand advertising.* Brand advertising revenues increased by \$8.8 million to \$29.8 million for the three months ended September 30, 2007 and increased by \$22.9 million to \$79.9 million for the nine months ended September 30, 2007 as compared to the corresponding three and nine month periods in 2006. The increase of \$8.8 million for the three months ended September 30, 2007 from the corresponding period in 2006 consisted of: (i) a \$9.7 million increase from advertisers who advertised with us during the three months ended September 30, 2007 but did not advertise on our Website during the three months ended September 30, 2006; (ii) a \$5.5 million increase in revenues from

advertisers who advertised with us in the three months ended September 30, 2006 and continued to do so in the three months ended September 30, 2007; and (iii) a \$6.4 million decrease in revenues as some of the advertisers who advertised with us during the three months ended September 30, 2006 did not advertise on our Website during the three months ended September 30, 2007. The increase of \$22.9 million for the nine months ended September 30, 2007 from the corresponding period in 2006 consisted of: (i) a \$17.7 million increase from advertisers who advertised with us during the nine months ended September 30, 2007 but did not advertise on our Website during the nine months ended September 30, 2006; (ii) a \$14.5 million increase in revenues from advertisers who advertised with us in the nine months ended September 30, 2006 and continued to do so in the nine months ended September 30, 2007; and (iii) a \$9.3 million decrease in revenues as some of the advertisers who advertised with us during the nine months ended September 30, 2006 did not advertise on our Website during the nine months ended September 30, 2007. No single customer accounted for more than 10% of total brand advertising revenues for each of the three and nine months ended September 30, 2007 and 2006. As of September 30, 2007 and 2006, we had \$1.2 million and \$1.0 million of receipt in advance from advertisers, respectively. We have not recorded any revenue from advertising-for-advertising barter transactions.

For the three and nine months ended September 30, 2007, we recorded brand advertising revenues of approximately \$455,000 and \$962,000, respectively, from Fujian Tian Qing Digital Co., Ltd. (or Fujian Tian Qing), formerly known as NetDragon Websoft Inc., in connection with its advertisements on our 17173.com Website. For the three and nine months ended September 30, 2006, we recorded brand advertising revenues of \$0 and approximately \$40,000, respectively, from Fujian Tian Qing. Those advertising services are provided pursuant to a three-year advertising framework agreement that expired in November 2006 and was extended to November 2009. Fujian Tian Qing was the previous owner of the 17173.com Website prior to our acquisition of 17173.com.

We expect brand advertising revenues to be flat or increase slightly in the fourth quarter of 2007 as compared to the third quarter of 2007.

*Sponsored search.* Sponsored search services revenues decreased by \$1.1 million to \$1.7 million for the three months ended September 30, 2007 and decreased by \$4.2 million to \$5.6 million for the nine months ended September 30, 2007, as compared to the corresponding three and nine month periods in 2006. Sponsored search services primarily include priority placements in our search directory and pay-for-click services of displaying the text-based links of our advertisers on our Websites and our Website Alliance network. Revenues from pay-for-click services accounted for approximately 30% of the total sponsored search revenues for both the three and nine month periods ended September 30, 2007 and for the corresponding periods in 2006. The decrease in sponsored search revenues was mainly resulted from our efforts to further strengthen our anti-fraudulent click-through mechanism starting from second half of 2006 which resulted in a decrease in average click-through rates. We believe the improved anti-fraudulent click-through mechanism will provide benefits to our sponsored search business in the long run.

We expect sponsored search revenues to be flat in the fourth quarter of 2007 as compared to third quarter of 2007.

## **Non-advertising Revenues**

Non-advertising revenues are derived principally from online game, wireless and other services.

Non-advertising revenues were \$20.0 million and \$38.1 million or 39% and 31% of total revenues for the three and nine months ended September 30, 2007, as compared to \$11.5 million and \$33.1 million, or 33% of total revenues for both the three and nine month period in 2006.

For the three and nine months ended September 30, 2007, non-advertising revenues consisted of online game revenues of \$12.7 million and \$18.1 million, wireless revenues of \$6.8 million and \$19.0 million, and other services revenues of \$467,000 and \$943,000, respectively. For the three and nine months ended September 30, 2006, non-advertising revenues consisted of revenues from online game of \$2.2 million and \$6.4 million, wireless of \$8.8 million and \$25.8 million and other services of \$469,000 and \$792,000, respectively.

*Online game.* Our online game revenues are mainly derived from two game titles, namely Tian Long Ba Bu (or TLBB) and Blade Online (or BO). TLBB is our first in-house developed online game launched on May 9, 2007. BO was licensed from a local independent game development studio and launched in October 2004.

Online game revenues increased by \$10.5 million to \$12.7 million for the three months ended September 30, 2007 and increased by \$11.7 million to \$18.1 million for the nine months ended September 30, 2007, as compared to the corresponding periods in 2006. For the three months ended September 30, 2007, revenue derived from TLBB was \$10.9 million, representing 86% of total online game revenues. The increase in online game revenues was mainly due to increased user numbers, growing gamers' loyalty and higher monetization of TLBB in the three months ended September 30, 2007. The

quarterly active paying accounts (i.e. the aggregate number of accounts from which game points are utilized at least once during the quarter) of TLBB increased to 690,000 as compared to 209,000 of three months ended June 30, 2007, representing an increase of 230%. TLBB's peak concurrent users remained at a stable level of 400,000. On average, each active paying account of TLBB had generated a quarterly revenue of US\$16 (equivalent to RMB118) during this quarter as compared with US\$11 (equivalent to RMB82) for three months ended June 30, 2007.

Our success with TLBB in China has enabled to license the game overseas and in August 2007, we licensed it to an operator in Vietnam. During the three months ended September 30, 2007, we recorded revenues of \$116,000 for the license fees and usage-based royalties from this arrangement.

Online game revenues are collected through sale of our prepaid cards, which we sell in both virtual and physical form, to third party distributors and retailers. We account for proceeds from sale of prepaid game cards from distributors or retailers as advances from distributors in our consolidated balance sheet, prior to their registration to specific game accounts. Once a prepaid game card is registered to a specific game account, we account for related amounts as deferred revenues. As of September 30, 2007, we had advances from distributors of \$5.0 million and deferred revenues of \$1.3 million, respectively, as compared with \$0.8 million and \$0.7 million as of September 30, 2006.

We expect online game revenues to increase in the fourth quarter of 2007 as compared with the third quarter of 2007.

*Wireless.* Our wireless revenues include SMS, RBT, WAP, MMS and IVR services. Our wireless services include news, weather forecast, chatting, entertainment information, music, ring tone, picture and logo downloads and various other related products provided to mobile phone users. Most of our services are charged on a monthly or per message/download basis. For the nine months ended September 30, 2007, we normally charged monthly fees ranging from \$0.065 to \$3.986 and per message/download fees ranging from approximately \$0.006 to \$0.531.

For the three months ended September 30, 2007, our wireless revenues decreased by \$2.0 million to \$6.8 million as compared to \$8.8 million for the three months ended September 30, 2006, primarily due to a decrease of \$2.1 million in SMS revenues and a decrease of \$1.5 million in WAP revenues. This decrease was partially offset by an increase of \$1.6 million in RBT and IVR and MMS revenues. For the nine months ended September 30, 2007, our wireless revenues decreased by \$6.8 million to \$19.0 million as compared to \$25.8 million for the nine months ended September 30, 2006, primarily due to a decrease of \$5.9 million in SMS revenues, a decrease of \$3.7 million in WAP revenues and a decrease of \$0.4 million in MMS revenues. This decrease was partially offset by an increase of \$3.2 million in RBT and IVR revenues. The decrease in SMS revenues was primarily due to the ongoing negative impact of policies such as double confirmation, billing reminders and details of promotion adopted by SPs issued by mobile network operators starting from July 2006. The decrease in WAP revenues was primarily due to the continuing negative impact of operational policy changes, which include limitations on promotion activities for WAP products and the sending of fee reminders to WAP service users, issued by a mobile network operator since late 2006.

Assuming that there are no further regulatory changes, we expect wireless revenues to be flat or decrease slightly in the fourth quarter of 2007, as compared to third quarter of 2007.

*Others.* Our other services mainly consist of sales of software to third parties. For the three months ended September 30, 2007 and 2006, revenues from the sales of software and applications service provider (or ASP) services were \$85,000 and \$423,000, respectively. For the nine months ended September 30, 2007 and 2006, revenues from the sales of software and ASP services were \$201,000 and \$673,000, respectively.

## **COSTS AND EXPENSES**

In quarters prior to April 1, 2007, costs and expenses associated with our online game segment were related to product development and research and an insignificant amount was related to online game operations. Accordingly, we had recorded all such costs and expenses in product development expenses in its statements of operations. Beginning April 1, 2007, in order to better present results of operations to enhance comparability with industry peers, we decided to reclassify the costs and expenses associated with our online game operations, which mainly consist of salaries and benefits of game masters, from product development expenses to cost of online game revenues. To conform with current period presentations, the relevant amounts for prior periods have been reclassified accordingly. Such reclassification amounted to \$296,000 for the three months ended September 30, 2006, and \$938,000 for the nine months ended September 30, 2006.

### **Cost of Revenues**

Total cost of revenues were \$17.2 million and \$45.8 million for the three and nine months ended September 30, 2007, respectively, as compared to \$12.7 million and \$35.5 million for the corresponding three and nine month periods in 2006.

### **Cost of Advertising Revenues**

Cost of advertising revenues increased by \$4.2 million to \$11.6 million for the three months ended September 30, 2007 as compared to the corresponding period in 2006, and increased by \$12.3 million to \$32.0 million for the nine months ended September 30, 2007 as compared to the corresponding period in 2006.

*Brand advertising.* Cost of brand advertising revenues includes personnel costs and overheads relating to our editorial center, content purchases, payments to our business partners, relevant depreciation of servers and computer equipment and bandwidth leasing costs. Cost of brand advertising revenues was \$10.3 million and \$27.7 million for the three and nine months ended September 30, 2007, respectively, as compared to \$6.2 million and \$16.1 million for the corresponding three and nine month periods in 2006. The increase of \$4.1 million for the three months ended September 30, 2007 from the corresponding period in 2006 consisted of a \$1.3 million increase in content purchases, a \$902,000 increase in payments to our business partners, a \$739,000 increase in personnel expense, a \$617,000 increase in bandwidth leasing costs due to increased traffic of our Websites, a \$430,000 increase in office and depreciation expense and a \$112,000 increase in other costs. The increase of \$11.6 million for the nine months ended September 30, 2007 from the corresponding period in 2006 consisted of a \$3.7 million increase in content purchases, a \$2.9 million increase in personnel expense, a \$1.7 million increase in payments to our business partners, a \$1.6 million increase in bandwidth leasing costs, a \$1.1 million increase in office and depreciation expense and a \$600,000 increase in other costs. Our brand advertising gross margin for the three and nine months ended September 30, 2007 was 66% and 65%, as compared to 71% and 72% for the corresponding periods in 2006, respectively. The decrease was mainly because of increased spending on content costs, bandwidth leasing costs and server depreciation costs.

*Sponsored search.* Cost of sponsored search revenues consists primarily of payments to our Website Alliance, relevant depreciation of servers and computer equipment, bandwidth leasing costs, personnel costs and data collection cost. Cost of sponsored search revenues was \$1.3 million and \$4.3 million for the three and nine months ended September 30, 2007, respectively, as compared to \$1.2 million and \$3.6 million for the corresponding three and nine month periods in 2006. The increase of \$700,000 in cost of sponsored search revenues for the nine months ended September 30, 2007 as compared to the corresponding period in 2006 resulted from an increase of \$989,000 in relevant depreciation and bandwidth leasing costs, offset by a decrease of \$289,000 in other costs. Our sponsored search gross margin for the three and nine months ended September 30, 2007 was 24% and 23%, respectively, as compared to 57% and 64% for the corresponding periods in 2006, respectively. Our sponsored search gross margin decreased for the three and nine months ended September 30, 2007 mainly

due to lower revenue but higher server depreciation and bandwidth leasing costs in relation to the launch of Sogou 3.0 in late 2006.

### **Cost of Non-advertising Revenues**

Cost of non-advertising revenues were \$5.6 million and \$13.9 million for the three and nine months ended September 30, 2007, respectively, as compared to \$5.3 million and \$15.8 million for the corresponding three and nine month periods in 2006.

*Online game.* Cost of online game revenues primarily consists of personnel costs relating to the operation of the games, bandwidth leasing costs, revenue sharing with the game developer of BO and depreciation of servers and computer equipment. Cost of online game revenues was \$2.1 million and \$4.3 million for the three and nine months ended September 30, 2007, respectively, as compared to \$1.0 million and \$3.0 million for the corresponding periods in 2006. The increase in cost of online game revenues was mainly due to increased server depreciation and bandwidth leasing costs as we added more servers to meet the demand of our increased players in connection with the launch of TLBB, and increase of personnel costs relating to the operation of the games. Our online game gross margins were 84% and 76% for the three and nine months ended September 30, 2007, as compared to 55% and 53% for the corresponding periods in 2006. The increases primarily represent contribution from TLBB.

*Wireless.* Cost of wireless revenues mainly consists of collection and wireless transmission charges paid to mobile network operators, expenses related to complaints based on allegations of breaches of certain provisions of our agreements with mobile network operators, fees or royalties paid to third party content providers for services and content associated with our wireless services, payments to third party wireless service alliances, relevant depreciation of servers and computer equipment and bandwidth leasing costs. Cost of wireless revenues decreased by \$0.8 million to \$3.3 million for the three months ended September 30, 2007, and decreased by \$3.3 million to \$9.1 million for the nine months ended September 30, 2007, as compared to the corresponding three and nine month periods in 2006. The decrease in cost of wireless revenues for the three months ended September 30, 2007 as compared to the corresponding period in 2006 resulted from a decrease of \$1.5 million in collection charges and transmission charges paid to mobile network operators, which was offset by a \$0.7 million increase in amounts paid to third party wireless service alliances and content providers. The decrease in cost of wireless revenues for the nine months ended September 30, 2007 as compared to the corresponding period in 2006 resulted from a decrease of \$4.7 million in collection charges and transmission charges paid to mobile network operators, which was offset by a \$1.4 million increase in amounts paid to third party wireless service alliances and content providers. Our wireless gross margins were both 52% for the three and nine months ended September 30, 2007, as compared to 54% and 52% for the corresponding periods in 2006.

*Others.* Cost of revenues for other services was \$178,000 and \$409,000 for the three and nine months ended September 30, 2007, respectively, as compared to \$200,000 and \$425,000 for the corresponding three and nine month periods in 2006. Cost of revenues for other services consists mainly of personnel and other expenses in connection with sale of software business and provision of ASP services.

### **Product Development Expenses**

Product development expenses increased by \$2.1 million to \$6.9 million for the three months ended September 30, 2007, and increased by \$4.0 million to \$17.0 million for the nine months ended September 30, 2007, as compared to the corresponding three and nine month periods in 2006. The increase for the three months ended September 30, 2007 from the corresponding period in 2006 was mainly due to \$2.2 million increase in personnel expenses resulting from an increase in headcount and salaries. The increase for the nine months ended September 30, 2007 from the corresponding period in 2006 was due to a

\$3.6 million increase in personnel expenses resulting from an increase in headcount and salaries, a \$893,000 increase in share-based compensation expense under SFAS 123(R), offset by a \$493,000 decrease in other expenses.

### **Sales and Marketing Expenses**

Sales and marketing expenses increased by \$6.4 million to \$13.6 million for the three months ended September 30, 2007, and increased by \$9.7 million to \$30.3 million for the nine months ended September 30, 2007, as compared to the corresponding three and nine month periods in 2006. The increase for the three months ended September 30, 2007 from the corresponding period in 2006 primarily consists of a \$4.5 million increase in advertising and promotion expense, which included the relevant expenses associated with our exclusive Olympic sponsorship in the Internet Content Services category, investment in corporate branding, marketing expenses for Sohu 3.0 and TLBB, a \$1.4 million increase in personnel expenses resulting from an increase in headcount, salaries and sales commission, a \$419,000 increase in traveling and entertainment expenses, and an \$81,000 increase in other expenses. The increase for the nine months ended September 30, 2007 from the corresponding period in 2006 primarily consists of a \$6.6 million increase in advertising and promotion expense, which included the relevant expenses associated with our exclusive Olympic sponsorship in the Internet Content Services category, investment in corporate branding, marketing expenses for Sohu 3.0 and TLBB, a \$2.2 million increase in personnel expenses resulting from an increase in headcount, salaries and sales commission, a \$674,000 increase in traveling and entertainment expenses, and a \$226,000 increase in other expenses.

### **General and Administrative Expenses**

General and administrative expenses increased by \$800,000 to \$4.9 million for the three months ended September 30, 2007, and increased by \$1.3 million to \$11.7 million for the nine months ended September 30, 2007, as compared to the corresponding three and nine month periods in 2006. The increase for the three months ended September 30, 2007 from corresponding period in 2006 was primarily due to a \$657,000 increase in personnel expenses resulting from an increase in headcount and salaries, a \$292,000 increase in fixed assets disposal, and offset by a \$149,000 decrease in other expenses. The increase for the nine months ended September 30, 2007 from corresponding period in 2006 was primarily due to an increase in share-based compensation expense under SFAS 123(R) of \$883,000, a \$544,000 increase in personnel expenses resulting from an increase in headcount and salaries, a \$370,000 increase in fixed assets disposal, and offset by a \$497,000 decrease in other expenses.

### **Amortization of Intangible Assets**

Amortization of intangible assets were \$202,000 and \$891,000 for the three and nine months ended September 30, 2007, respectively, as compared to \$509,000 and \$1.5 million for the three and nine months ended September 30, 2006, which were mainly related to the acquisitions of the 17173.com, Focus.cn, Goodfeel and Go2Map.

## Operating Profit

As a result of the foregoing, our operating profit increased by \$2.7 million to \$8.8 million for the three months ended September 30, 2007, and decreased by \$1.1 million to \$17.8 million for the nine months ended September 30, 2007, as compared to the corresponding three and nine month periods in 2006. The operating profit for the three and nine months ended September 30, 2007 included \$2.0 million and \$6.9 million, respectively, for share-based compensation expense recorded under SFAS 123(R). The operating profit for the three and nine months ended September 30, 2006 included \$1.9 million and \$4.9 million, respectively, for share-based compensation expense recorded under SFAS 123(R).

### **Other Income (Expenses)**

For the three months ended September 30, 2007, other income of \$575,000 mainly consisted of \$561,000 gain from disposal of interest in an associate. For the nine months ended September 30, 2007, other income of \$335,000 mainly consisted of \$561,000 gain from disposal of interest in an associate, which was offset by amortization, in the amount of \$248,000, of the offering costs of our zero coupon convertible senior notes. For the three months ended September 30, 2006, other expenses of \$78,000 mainly consisted of amortization of the offering costs of our zero coupon convertible senior notes. For the nine months ended September 30, 2006, other income of \$565,000 mainly consisted of \$793,000 of gain from early redemption of zero coupon convertible senior notes.

### **Interest Income**

For the three and nine months ended September 30, 2007, interest income was \$608,000 and \$2.4 million, as compared to \$951,000 and \$2.3 million for the three and nine months ended September 30, 2006. The decrease in the three months ended September 30, 2007 was mainly due to the repayment of our convertible notes of \$58.5 million in July, which decreased the average cash balance for the quarter.

### **Income Tax Expense**

For the three and nine months ended September 30, 2007, income tax expense was \$322,000 and \$767,000, as compared to \$351,000 and \$1.1 million for the three and nine months ended September 30, 2006.

Most of our income is earned by our China-based subsidiaries and VIEs. Our China-based subsidiaries and VIEs, Sohu Era, Sohu Internet, Sogou Information, Sogou Technology and Sohu Media enjoy tax benefits which are available to new technology enterprises. Furthermore, they are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction at the rate of 7.5% for the subsequent three years and 15% thereafter.

Income earned in the United States, where Sohu.com Inc. is incorporated, is subject to taxation at 34% or 35%. For the foreseeable future, we anticipate the major source of income earned in the United States and subject to United States taxation to be interest income. If dividends are paid by our China or other non-U.S. subsidiaries to Sohu.com Inc., the dividends would be taxed at Sohu.com Inc.'s rate of taxation which is 34% or 35% (as reduced by any applicable deemed-paid foreign tax credits for foreign income taxes paid by such subsidiaries). For the foreseeable future, we do not intend for the China or other non-U.S. subsidiaries to pay dividends to Sohu.com Inc.

### **Minority Interests**

On October 31, 2006, we completed the acquisition of a 70% interest in 21 East HK and 21 East Beijing (collectively 21 East ), an entertainment company. The acquisition was accounted for as a purchase business combination and the results of operations from the acquisition date have been included in our consolidated financial statements, resulting in minority interests of \$12,000 and \$42,000 for the three and nine months ended September 30, 2007, respectively.

### **Net Income from Continuing Operations**

For the three and nine months ended September 30, 2007, net income from continuing operations was \$9.7 million and \$19.9 million, as compared to \$6.6 million and \$20.6 million for the three and nine months ended September 30, 2006.

### **Loss from Discontinued E-commerce Operations**

On June 20, 2006, we discontinued our e-commerce business. For the three and nine months ended September 30, 2007, loss from discontinued e-commerce operations was \$5,000 and \$18,000, as compared to \$27,000 and \$784,000 for the three and nine months ended September 30, 2006.

### **Net Income**

As a result of the foregoing, we had net income of \$9.7 million and \$19.9 million for the three and nine months ended September 30, 2007, as compared to net income of \$6.6 million and \$19.8 million for the three and nine months ended September 30, 2006. The net income for the three and nine months ended September 30, 2007 included \$2.0 million and \$6.9 million of share-based compensation expense recorded under SFAS 123(R), as compared to \$1.9 million and \$4.9 million for the three and nine months ended September 30, 2006.

### **LIQUIDITY AND CAPITAL RESOURCES**

We have financed our operations and capital expenditures principally through private sales of equity securities, the initial public offering of our common stock, a private placement of zero coupon convertible senior notes, and cash provided by operations. From inception through September 30, 2007, we have raised net proceeds of \$39.2 million through the sale of preferred stock in private placements, \$52.4 million from the sale of common stock in our initial public offering and \$87.4 million through the sale of zero coupon convertible senior notes, and generated cash flow from our operations.

We completed a private placement on July 14, 2003 of \$90.0 million principal amount of zero coupon convertible senior notes due July 2023, which resulted in net proceeds to Sohu of approximately \$87.4 million after deduction of the initial purchaser's discount and our offering expenses. The notes do not pay any interest, have a zero yield to maturity, and are convertible into Sohu's common stock at a conversion price of \$44.76 per share, subject to adjustment for dividends, distributions, and upon the occurrence of certain other events. Each \$1,000 principal of the notes is initially convertible into 22.3414 shares of Sohu's common stock. Each holder of the notes had the right, at the holder's option, to require Sohu to repurchase all or any portion of the principal amount of the holder's notes on July 14 in 2007, 2013 and 2018 at a price equal to 100% of the outstanding principal amount. Sohu may also redeem all or a portion of the notes for cash at any time on or after July 14, 2008 at 100% of the principal amount of the notes if the closing price of Sohu's common stock for each of the 30 consecutive trading days prior to such time was at least 130% of the conversion price or at such time at least 90% of the initial aggregate principal amount of the notes has been converted, repurchased or redeemed. In addition, upon a change of control event, each holder of the notes may require Sohu to repurchase some or all of its notes at a repurchase price equal to 100% of the principal amount of the notes. In 2005 and 2006, we early redeemed our zero coupon convertible senior notes with a face value of \$30.2 million at a discount. As of the end of the notification period associated with the July 14, 2007 repurchase date, note holders had

exercised their right to require us to repurchase principal on such notes in an aggregate amount of \$58.5 million. We repurchased such notes on July 16, 2007. After the redemption, as of September 30, 2007, the outstanding balance of our zero coupon convertible senior notes was \$1.3 million.

In summary, our cash flows were (in thousands):

|   | <b>Nine Months Ended</b> |             |
|---|--------------------------|-------------|
|   | <b>September 30,</b>     |             |
|   | <b>2007</b>              | <b>2006</b> |
| Net cash provided by operating activities                   | \$ 42,951                | \$ 22,285   |
| Net cash used in investing activities                       | (48,064)                 | (11,830)    |
| Net cash used in financing activities                       | (49,918)                 | (25,374)    |
| Effect of exchange rate change on cash and cash equivalents | 2,177                    | 1,847       |
| Net decrease in cash and cash equivalents                   | (52,854)                 | (13,072)    |
| Cash and cash equivalents at beginning of period            | 124,756                  | 119,091     |
| Cash and cash equivalents at end of period                  | \$ 71,902                | \$ 106,019  |

For the nine months ended September 30, 2007, net cash provided by operating activities was \$43.0 million. This was primarily attributable to our net income of \$19.9 million, adjusted by non-cash items of depreciation and amortization of \$9.4 million, share-based compensation of \$6.9 million, provision for allowance for doubtful accounts of \$1.2 million, and a \$5.6 million increase in working capital. For the nine months ended September 30, 2006, net cash provided by operating activities was \$22.3 million. This was primarily attributable to our net income of \$19.8 million, adjusted by non-cash items of depreciation and amortization of \$7.2 million, share-based compensation of \$4.9 million, provision for allowance for doubtful accounts of \$1.1 million. This increase was offset by gains on early redemption of zero coupon convertible senior notes of \$793,000 and net changes in current assets and liabilities of \$10.2 million.

For the nine months ended September 30, 2007, net cash used in investing activities was \$48.1 million, and was primarily attributable to \$49.2 million used in purchasing fixed assets and other assets, and \$1.1 million for earn-out payment for Go2Map, which was offset by a \$1.7 million proceeds from disposal of interest in an associate, and a \$493,000 decrease in restricted cash. For the nine months ended September 30, 2006, net cash used in investing activities was \$11.8 million, and was primarily attributable to \$7.8 million used in purchasing fixed assets and other assets, \$3.8 million increase of restricted cash and \$306,000 for earn-out payment for Focus.cn.

For the nine months ended September 30, 2007, net cash used in financing activities was \$49.9 million, and was primarily attributable to \$58.5 million used in redemption of zero coupon convertible senior notes and was offset by \$8.4 million cash collection from issuance of common stock upon the exercise of share-based awards granted under our stock incentive plan. For the nine months ended September 30, 2006, net cash used in financing activities was \$25.4 million, and was primarily attributable to \$15.0 million used in repurchase of common stock, \$14.1 million used in early redemption of zero coupon convertible senior notes and was partially offset by \$3.7 million cash collection from issuance of common stock upon the exercise of options granted under our stock incentive plan.

As of September 30, 2007, we had cash and cash equivalents of \$71.9 million, and investments in marketable debt securities of \$5.0 million, totaling approximately \$76.9 million as compared to \$129.7 million as of December 31, 2006.

We believe that our current total cash balance will be sufficient to meet anticipated working capital needs (net cash used in operating activities), redemption of convertible senior notes, commitments and capital expenditures for at least the next twelve months. We may, however, require additional cash resources due to changed business conditions or other future developments, including any investments or acquisitions we may decide to pursue.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS

#### FOREIGN CURRENCY EXCHANGE RATE RISK

While our reporting currency is the US 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 US Dollars and RMB. If the RMB depreciates against the US Dollar, the value of our RMB revenues and assets as expressed in our US 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 US Dollar. The exchange rate of the RMB against the US Dollar was adjusted to RMB 8.11 per US 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 US 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 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. 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 provides information, by maturity date, regarding our foreign currency sensitive financial instruments, which consist of cash and cash equivalents, restricted cash, receivables, investments in marketable debt securities, payables and zero coupon convertible senior notes as of September 30, 2007:

|   | Expected Maturity Date |       |      |      |      |            | Total<br>Recorded<br>Value | Fair<br>Value |
|---|------------------------|-------|------|------|------|------------|----------------------------|---------------|
|   | Before September 30,   |       |      |      |      |            |                            |               |
|   | 2008                   | 2009  | 2010 | 2011 | 2012 | Thereafter |                            |               |
| <b>On-balance sheet<br/>financial instruments<br/>(in US\$ 000)</b> |                        |       |      |      |      |            |                            |               |
| Cash and cash equivalents   |                        |       |      |      |      |            |                            |               |
| in US\$   | 15,983                 | -     | -    | -    | -    | -          | 15,983                     | 15,983        |
| in RMB  | 55,426                 | -     | -    | -    | -    | -          | 55,426                     | 55,426        |
| in HK\$   | 493                    | -     | -    | -    | -    | -          | 493                        | 493           |
| Sub-total   | 71,902                 | -     | -    | -    | -    | -          | 71,902                     | 71,902        |
| Restricted cash   |                        |       |      |      |      |            |                            |               |
| in US\$   | 1,250                  | 1,500 | -    | -    | -    | -          | 2,750                      | 2,750         |
| in RMB  | -                      | 1,531 | -    | -    | -    | -          | 1,531                      | 1,531         |
| Sub-total   | 1,250                  | 3,031 | -    | -    | -    | -          | 4,281                      | 4,281         |
| Receivables   |                        |       |      |      |      |            |                            |               |
| in US\$   | 1,429                  | -     | -    | -    | -    | -          | 1,429                      | 1,429         |
| in RMB  | 41,824                 | -     | -    | -    | -    | -          | 41,824                     | 41,824        |
| in HK\$   | 55                     | -     | -    | -    | -    | -          | 55                         | 55            |
| Sub-total   | 43,308                 | -     | -    | -    | -    | -          | 43,308                     | 43,308        |
| Investments in marketable debt securities                           |                        |       |      |      |      |            |                            |               |
| in US\$   | 4,988                  | -     | -    | -    | -    | -          | 4,988                      | 4,988         |
| Payables  |                        |       |      |      |      |            |                            |               |
| in US\$   | 4,849                  | -     | -    | -    | -    | -          | 4,849                      | 4,849         |
| in RMB  | 50,472                 | -     | -    | -    | -    | -          | 50,472                     | 50,472        |
| in HK\$   | 168                    | -     | -    | -    | -    | -          | 168                        | 168           |
| Sub-total   | 55,489                 | -     | -    | -    | -    | -          | 55,489                     | 55,489        |

Zero coupon convertible  
senior notes

|         |   |   |   |   |   |       |       |       |
|---------|---|---|---|---|---|-------|-------|-------|
| in US\$ | - | - | - | - | - | 1,256 | 1,256 | 1,256 |
|---------|---|---|---|---|---|-------|-------|-------|

**INVESTMENT RISK**

Sohu invests in marketable debt securities to preserve principal while at the same time maximizing yields without significantly increasing risk. These marketable debt securities are classified as available-for-sale because we may dispose of the securities prior to maturity and they are thus reported at the market value as of the end of the period. As of September 30, 2007, an unrealized loss of \$12,000 was recorded as accumulated other comprehensive income in shareholders equity.

**INTEREST RATE RISK**

Our investment policy limits our investments of excess cash in high-quality corporate securities and limits the amount of credit exposure to any one issuer. We protect and preserve our invested funds by limiting default, market and reinvestment risk.

Investments in fixed rate debt securities carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates. Due in part to these factors, our future interest income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities, which have declined in market value due to changes in interest rates.

The following table provides information, by maturity date, regarding our interest rate sensitive financial instruments, which consist of marketable debt securities and zero coupon convertible senior notes as of September 30, 2007:

| (in US\$ '000)                              | <b>Expected Maturity Date</b> |             |                             |             |             |                   | <b>Total Recorded</b> |                   |
|---|-------------------------------|-------------|-----------------------------|-------------|-------------|-------------------|-----------------------|-------------------|
|   | <b>2008</b>                   | <b>2009</b> | <b>Before September 30,</b> |             |             | <b>Thereafter</b> | <b>Value</b>          | <b>Fair Value</b> |
|   |                               |             | <b>2010</b>                 | <b>2011</b> | <b>2012</b> |                   |                       |                   |
| <b>Investments in marketable securities</b> | 4,988                         | -           | -                           | -           | -           | -                 | 4,988                 | 4,988             |
| Average interest rate                       | 4.40%                         | -           | -                           | -           | -           | -                 |                       |                   |
| <b>Zero coupon convertible senior notes</b> | -                             | -           | -                           | -           | -           | 1,256             | 1,256                 | 1,256             |
| Average interest rate                       | -                             | -           | -                           | -           | -           | 0.00%             |                       |                   |

**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 are no material legal proceedings pending or, to our knowledge, threatened against us. From time to time we become subject to legal proceedings and claims in the ordinary course of our business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights, and a variety of claims arising in connection with our email, message boards, other communications and community features, such as claims alleging defamation or invasion of privacy.

However, such legal proceedings or claims, even if not meritorious, could result in the expenditure of significant financial and management resources.

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

Under existing tax laws, dividends distributed by a foreign invested enterprise to its investors outside the PRC are exempted from withholding tax. It is reported that the PRC government intends to levy withholding tax upon such dividends beginning January 1, 2008. Should the PRC government proceed to enact legislation imposing such a withholding tax, our China-based subsidiaries, Sohu Era, Sohu Media, Sogou Technology and AmazGame, may be subject to withholding tax in the event that they distribute dividends to our non-PRC holding companies. There are no other 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, 2006 filed with the SEC on March 8, 2007 and in Part I, Item 2 of our Quarterly Report on Form 10-Q for the three months ended June 30, 2007 filed with the SEC on August 6, 2007.

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

### Use of Proceeds

On July 17, 2000, we completed an underwritten initial public offering of our 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. We 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. Our 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 us.

During the nine months ended September 30, 2007, we did not use any proceeds from the offering. The remaining net proceeds from the offering have been invested in cash, cash equivalents, and marketable debt securities. 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. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

Please see the Exhibits Index attached hereto.

**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: November 7, 2007

**SOHU.COM INC.**

By:

/s/ Carol Yu

Co-President and Chief Financial Officer

**EXHIBITS INDEX**

|      |   |
|------|---|
| 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                  |

I, Charles Zhang, certify that:

1.

I have reviewed this quarterly report on Form 10-Q of Sohu.com Inc.;

2.

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.

Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.

The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a)

Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b)

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles;

c)

Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d)

Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

and

5.

The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a)

All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b)

Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 7, 2007

/s/ Charles Zhang

Chief Executive Officer and Chairman of the  
Board of Directors

I, Carol Yu, certify that:

1.

I have reviewed this quarterly report on Form 10-Q of Sohu.com Inc.;

2.

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.

Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.

The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a)

Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b)

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles;

c)

Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d)

Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

and

5.

The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a)

All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b)

Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 7, 2007

/s/ Carol Yu

Co-President and Chief Financial Officer

SOHU.COM INC.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF  
THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Sohu.com Inc. (the Company) on Form 10-Q for the period ended September 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the Report), I, Charles Zhang, Chief Executive Officer and Chairman of the Board of Directors of the Company, certify, pursuant to U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition of the Company as of September 30, 2007 and results of operations of the Company for the three months ended September 30, 2007.

/s/ Charles Zhang

Charles Zhang, Chief Executive Officer and  
Chairman of the Board of Directors

November 7, 2007

SOHU.COM INC.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF  
THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Sohu.com Inc. (the Company) on Form 10-Q for the period ended September 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the Report), I, Carol Yu, Co-President and Chief Financial Officer of the Company, certify, pursuant to U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition of the Company as of September 30, 2007 and results of operations of the Company for the three months ended September 30, 2007.

/s/ Carol Yu

Carol Yu, Co-President and Chief Financial Officer  
November 7, 2007