Expedia, Inc.
Form 10-Q
November 08, 2007

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

FORM 10-Q

þ **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

o **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: 000-51447

EXPEDIA, INC.
(Exact name of registrant as specified in its charter)

Delaware	**20-2705720**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

3150 139th Avenue SE
Bellevue, WA 98005

(Address of principal executive office) (Zip Code)
(425) 679-7200

(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 þ No o

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.

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

The number of shares outstanding of each of the registrant s classes of common stock as of October 26, 2007 was:

Common stock, $0.001 par value per share	258,901,117 shares
Class B common stock, $0.001 par value per share	25,599,998 shares

Expedia, Inc.
Form 10-Q
For the Quarter Ended September 30, 2007
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Part I. Item 1. Consolidated Financial Statements

EXPEDIA, INC.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data)
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenue	$ 759,596	$ 613,942	$ 2,000,030	$ 1,706,298
Cost of revenue (1)	151,053	133,094	415,997	380,857
Gross profit	608,543	480,848	1,584,033	1,325,441
Operating expenses:				
Selling and marketing (1)	279,341	215,086	757,514	614,778
General and administrative (1)	83,365	66,156	235,261	210,570
Technology and content (1)	47,452	36,034	131,215	104,866
Amortization of intangible assets	18,613	26,569	59,312	86,860
Impairment of intangible asset		47,000		47,000
Amortization of non-cash distribution and marketing		711		9,578
Operating income	179,772	89,292	400,731	251,789
Other income (expense):				
Interest income	12,888	9,697	30,709	20,332
Interest expense	(13,940)	(4,857)	(35,018)	(7,230)
Other, net	(13,894)	2,926	(13,453)	17,049
Total other income (expense), net	(14,946)	7,766	(17,762)	30,151
Income before income taxes and minority interest	164,826	97,058	382,969	281,940
Provision for income taxes	(65,542)	(37,707)	(153,230)	(103,523)
Minority interest in (income) loss of consolidated subsidiaries, net	311	(374)	768	(623)
Net income	$ 99,595	$ 58,977	$ 230,507	$ 177,794
Net earnings per share available to common stockholders:				
Basic	$ 0.34	$ 0.18	$ 0.77	$ 0.52
Diluted	0.32	0.17	0.72	0.50
Shares used in computing earnings per share:				
Basic	292,171	330,359	300,959	340,660

Diluted	312,756	341,137	318,848	355,075
(1) Includes stock-based compensation as follows:				
Cost of revenue	$ 550	$ 1,816	$ 2,079	$ 6,627
Selling and marketing	2,729	2,968	8,768	11,665
General and administrative	7,683	7,043	22,356	25,483
Technology and content	3,455	4,612	11,046	13,772
Total stock-based compensation	$ 14,417	$ 16,439	$ 44,249	$ 57,547

See accompanying notes.

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EXPEDIA, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	September 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 836,531	$ 853,274
Restricted cash and cash equivalents	20,748	11,093
Accounts and notes receivable, net of allowance of $5,226 and $4,874	317,901	211,430
Prepaid merchant bookings	71,986	39,772
Deferred income taxes, net	275	4,867
Prepaid expenses and other current assets	71,279	62,249
Total current assets	1,318,720	1,182,685
Property and equipment, net	152,941	137,144
Long-term investments and other assets	89,006	59,289
Intangible assets, net	988,525	1,028,774
Goodwill	5,912,934	5,861,292
TOTAL ASSETS	$ 8,462,126	$ 8,269,184
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable, merchant	$ 823,351	$ 600,192
Accounts payable, other	185,868	120,545
Deferred merchant bookings	818,474	466,474
Deferred revenue	13,765	10,317
Income taxes payable	52,522	30,902
Other current liabilities	196,858	171,695
Total current liabilities	2,090,838	1,400,125
Long-term debt	500,000	500,000
Credit facility	500,000	
Deferred income taxes, net	362,398	369,297
Other long-term liabilities	104,052	33,716
Minority interest	62,590	61,756
Commitments and contingencies		
Stockholders equity:		
Preferred stock $.001 par value		
Authorized shares: 100,000,000		
Series A shares issued and outstanding: 776 and 846		
Common stock $.001 par value		

Authorized shares: 1,600,000,000		
Shares issued: 332,539,633 and 328,066,276		
Shares outstanding: 255,005,709 and 305,901,048	333	328
Class B common stock $.001 par value		
Authorized shares: 400,000,000		
Shares issued and outstanding: 25,599,998 and 25,599,998	26	26
Additional paid-in capital	5,996,099	5,903,200
Treasury stock Common stock, at cost Shares: 77,533,924 and 22,165,228	(1,717,922)	(321,155)
Retained earnings	536,847	309,912
Accumulated other comprehensive income	26,865	11,979
Total stockholders equity	4,842,248	5,904,290
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 8,462,126	$ 8,269,184

See accompanying notes.

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EXPEDIA, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Operating activities:		
Net income	$ 230,507	$ 177,794
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	43,381	35,834
Amortization of intangible assets, non-cash distribution and marketing and stock-based compensation	103,561	153,985
Deferred income taxes	(3,297)	(31,702)
Unrealized (gain) loss on derivative instruments, net	5,938	(11,609)
Equity in (income) loss of unconsolidated affiliates	3,848	(2,331)
Minority interest in income (loss) of consolidated subsidiaries, net	(768)	623
Impairment of intangible asset		47,000
Foreign exchange gain on cash and cash equivalents, net	(18,669)	(23,274)
Other	3,362	785
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts and notes receivable	(94,431)	(39,767)
Prepaid merchant bookings and prepaid expenses	(38,674)	(30,178)
Accounts payable, other and other current liabilities	154,180	103,189
Accounts payable, merchant	221,084	122,307
Deferred merchant bookings	351,969	216,911
Deferred revenue	3,365	4,001
Net cash provided by operating activities	965,356	723,568
Investing activities:		
Capital expenditures	(57,620)	(67,580)
Acquisitions, net of cash acquired	(59,622)	(29,830)
Increase in long-term investments and deposits	(29,677)	(1,820)
Net cash used in investing activities	(146,919)	(99,230)
Financing activities:		
Credit facility borrowings	650,000	
Credit facility repayments	(150,000)	(230,649)
Proceeds from issuance of long-term debt, net of issuance costs		495,682
Changes in restricted cash and cash equivalents	(10,630)	(2,604)
Proceeds from exercise of equity awards	45,398	29,360
Excess tax benefit on equity awards	2,676	781
Treasury stock activity	(1,396,012)	(295,105)
Other, net	(844)	

Net cash used in financing activities	(859,412)	(2,535)
Effect of exchange rate changes on cash and cash equivalents	24,232	26,473
Net increase (decrease) in cash and cash equivalents	(16,743)	648,276
Cash and cash equivalents at beginning of period	853,274	297,416
Cash and cash equivalents at end of period	$ 836,531	$ 945,692
Supplemental cash flow information		
Cash paid for interest	$ 41,381	$ 3,796
Income tax payments, net	69,751	63,955

See accompanying notes.

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Notes to Consolidated Financial Statements
September 30, 2007
(Unaudited)

Note 1 Basis of Presentation

Description of Business

Expedia, Inc. and its subsidiaries provide travel products and services to leisure and corporate travelers in the United States and abroad. These travel products and services are offered through a diversified portfolio of brands including: Expedia.com®, Hotels.com®, Hotwire.com™, our private label programs (Worldwide Travel Exchange and Interactive Affiliate Network), Classic Vacations, Expedia® Corporate Travel (ECT), eLong™ Inc. (eLong) and TripAdvisor®. In addition, many of these brands have related international points of sale. We refer to Expedia, Inc. and its subsidiaries collectively as Expedia, the Company, us, we and our in these consolidated financial stateme

Basis of Presentation

These accompanying financial statements present our results of operations, financial position and cash flows on a consolidated basis. The unaudited consolidated financial statements include Expedia, Inc., our wholly-owned subsidiaries, and entities we control, or in which we have a variable interest and are the primary beneficiary of future cash profits or losses. We have eliminated significant intercompany transactions and accounts.

We have prepared the accompanying unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial reporting. We have included all adjustments necessary for a fair presentation of the results of the interim period. These adjustments consist of normal recurring items. Our interim unaudited consolidated financial statements are not necessarily indicative of results that may be expected for any other interim period or for the full year. These interim unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2006, previously filed with the Securities and Exchange Commission (SEC).

Accounting Estimates

We use estimates and assumptions in the preparation of our interim unaudited consolidated financial statements in accordance with GAAP. Our estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of our interim unaudited consolidated financial statements. These estimates and assumptions also affect the reported amount of net income during any period. Our actual financial results could differ significantly from these estimates. The significant estimates underlying our interim unaudited consolidated financial statements include revenue recognition, recoverability of long-lived and intangible assets and goodwill, income taxes, potential settlements related to occupancy taxes, stock-based compensation and accounting for derivative instruments.

Reclassifications

We have reclassified prior period financial statements to conform to the current period presentation.

In our consolidated statement of cash flows for the nine months ended September 30, 2006, we reclassified net foreign exchange gains and losses on cash of U.S. functional subsidiaries held in foreign currencies from operating cash flows to effect of exchange rate changes on cash and cash equivalents to appropriately reflect foreign currency impacts on cash and cash equivalents for the periods presented.

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Notes to Consolidated Financial Statements (Continued)

Seasonality

We generally experience seasonal fluctuations in the demand for our travel products and services. For example, traditional leisure travel bookings are generally the highest in the first three quarters of the year as travelers plan and book their spring, summer and holiday travel. The number of bookings typically decreases in the fourth quarter. Because revenue in the merchant business is generally recognized when the travel takes place rather than when it is booked, revenue typically lags bookings by several weeks or longer. As a result, revenue is typically the lowest in the first quarter and highest in the third quarter.

Note 2 Summary of Significant Accounting Policies

Income Taxes

In accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, we record income taxes under the liability method. Deferred tax assets and liabilities reflect our estimate of the future tax consequences of temporary differences between the carrying amounts of assets and liabilities for book and tax purposes. We determine deferred income taxes based on the differences in accounting methods and timing between financial statement and income tax reporting. Accordingly, we determine the deferred tax asset or liability for each temporary difference based on the enacted tax rates in effect for the years in which we expect to realize the underlying items of income and expense. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent earnings experience by jurisdiction, expectations of future taxable income, and the carryforward periods available to us for tax reporting purposes, as well as other relevant factors. We may establish a valuation allowance to reduce deferred tax assets to the amount we believe is more likely than not to be realized. Due to inherent complexities arising from the nature of our businesses, future changes in income tax law, tax sharing agreements or variances between our actual and anticipated operating results, we make certain judgments and estimates. Therefore, actual income taxes could materially vary from these estimates.

For the period January 1, 2005 through the date of our separation from IAC/InterActiveCorp (IAC) on August 9, 2005 (the Spin-Off), we were a member of the IAC consolidated tax group. Accordingly, IAC filed a federal income tax return and certain state income tax returns on a combined basis with us for that period. IAC paid the entire combined income tax liability related to these filings. As such, our estimated income tax liability for that period was transferred to IAC upon Spin-Off. Under the terms of the Tax Sharing Agreement, IAC could make certain elections in preparation of these tax returns, which changed the amount of income taxes owed for the period before the Spin-Off. We recorded those changes as adjustments to stockholders equity in accordance with Emerging Issues Task Force No. 94-10, *Accounting by a Company for the Income Tax Effects of Transactions Among or With its Shareholders under FASB Statement 109.*

On January 1, 2007, we adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 gives guidance related to the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and requires that we recognize in our financial statements the impact of a tax position, if that position is more likely than not to be sustained upon an examination, based on the technical merits of the position. As a result of the adoption of FIN 48, we recognized an approximately $18.9 million increase in the liability for uncertain tax positions, of which $14.7 million of the increase was accounted for as an increase to the January 1, 2007 balance of goodwill as the underlying tax positions related to business combinations and $4.2 million as a reduction to the January 1, 2007 balance of retained earnings. These amounts do not include the federal tax benefits associated with these positions, which are immaterial.

As of January 1, 2007, we had $65.5 million of liabilities for uncertain tax positions, $14.0 million of which, if recognized, would decrease our provision for income taxes. We recognize interest and penalties related to our liabilities for uncertain tax positions in income tax expense. As of January 1, 2007 and September 30, 2007, we had approximately $5.4 million and $10.6 million accrued for the potential payment of estimated interest and penalties. For the nine months ended September 30, 2007, we recognized $3.3 million of interest and penalties, net of federal benefit related to our liabilities for uncertain tax positions.

Notes to Consolidated Financial Statements (Continued)

We file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. We are no longer subject to tax examinations by tax authorities for years prior to 1998.

Certain Risks and Concentrations

Our business is subject to certain risks and concentrations including dependence on relationships with travel suppliers, primarily airlines and hotels, dependence on third-party technology providers, exposure to risks associated with online commerce security and credit card fraud. In particular, we rely on our overall relationships with the major airlines. We also rely on global distribution system partners and third-party service providers for certain fulfillment services, including one third-party service provider for which we accounted for approximately 47% of its total revenue for the year ended December 31, 2006 and approximately 39% of its total revenue for the six months ended June 30, 2007.

New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS 157 applies when another standard requires or permits assets or liabilities to be measured at fair value. Accordingly, SFAS 157 does not require any new fair value measurements. SFAS 157 is effective in fiscal years beginning after November 15, 2007. We are in the process of determining the impact, if any, of this statement on our results from operations, financial position or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of SFAS Statement No. 115* (SFAS 159), which is effective for fiscal years beginning after November 15, 2007. SFAS 159 permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. We are in the process of determining the impact, if any, of this statement on our results from operations, financial position or cash flows.

Note 3 Intangibles, net

Our indefinite lived intangible assets relate principally to trade names and trademarks acquired in various acquisitions. As of September 30, 2006, we determined that our indefinite lived trade name intangible asset related to Hotwire was impaired. Accordingly, during the three months ended September 30, 2006, we performed a valuation of that asset, determined that its carrying amount exceeded its fair value and recognized an impairment charge of $47.0 million. We based our measurement of fair value of the trade name intangible asset using the relief-from-royalty method. This method assumes that a trade name has value to the extent that its owner is relieved of the obligation to pay royalties for the benefits received therefrom.

Note 4 Debt

Credit Facility

In July 2005, we entered into a $1.0 billion five-year unsecured revolving credit facility with a group of lenders, which is unconditionally guaranteed by certain Expedia subsidiaries and expires in August 2010. We had $500.0 million outstanding under the revolving credit facility as of September 30, 2007. No amounts were outstanding under the facility as of December 31, 2006. The facility bears interest based on market interest rates plus a spread, which is determined based on our financial leverage. The interest rate was 6.3125% as of September 30, 2007.

The amount of stand-by letters of credit issued under the facility reduces the amount available to us. As of September 30, 2007 and December 31, 2006, there was $51.9 million and $52.0 million of outstanding stand-by letters of credit issued under the facility.

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Notes to Consolidated Financial Statements (Continued)

Long-term Debt

In August 2006, we privately placed $500.0 million of senior unsecured notes due 2018. In March 2007, we completed an offer to exchange these notes for registered notes having substantially the same financial terms and covenants as the original notes (the unregistered and registered notes collectively, the Notes). The Notes bear a fixed rate interest of 7.456% with interest payable semi-annually in February and August of each year. The amount of accrued interest related to the Notes was $4.7 million and $13.4 million as of September 30, 2007 and December 31, 2006. The Notes are repayable in whole or in part on August 15, 2013, at the option of the holders of such Notes, at 100% of the principal amount plus accrued interest. We may redeem the Notes in accordance with the terms of the agreement, in whole or in part, at any time at our option.

The Notes are senior unsecured obligations guaranteed by certain domestic Expedia subsidiaries and rank equally in right of payment with all of our existing and future unsecured and unsubordinated obligations. For further information, see Note 13 Guarantor and Non-Guarantor Supplemental Financial Information.

Note 5 Derivative Instruments

The fair value of our derivative financial instruments generally represents the estimated amounts we would expect to receive or pay upon termination of the contracts as of the reporting date.

As a result of the Spin-Off, we assumed certain obligations of IAC related to IAC s Ask Jeeves Convertible Subordinated Notes (Ask Jeeves Notes). As of September 30, 2007 and December 31, 2006, the related derivative liability balance was $14.8 million included in other current liabilities and $15.9 million included in other long-term liabilities on our consolidated balance sheets. During the nine months ended September 30, 2007, certain of these notes were converted and we released approximately 0.3 million shares of our common stock from escrow with a fair value of $6.6 million to satisfy the conversion requirements. During the three months ended September 30, 2007 and 2006, we recognized a net loss of $1.3 million and $0.6 million related to these Ask Jeeves Notes. During the nine months ended September 30, 2007 and 2006, we recognized a net loss of $5.5 million and a net gain of $11.5 million related to these Ask Jeeves Notes.

As of September 30, 2007, we estimate that we could be required to release from escrow up to 0.5 million shares of our common stock (or pay cash in equal value, in lieu of issuing such shares). The Ask Jeeves Notes are due June 1, 2008; upon maturity of these notes, our obligation to satisfy demands for conversion ceases.

We entered into cross-currency swaps to hedge against the change in value of certain intercompany loans denominated in currencies other than the lending subsidiaries functional currency. These swaps have been designated as cash flow hedges and are re-measured at fair value each reporting period. As of September 30, 2007 and December 31, 2006, the related derivative liability balances were $21.1 million and $13.1 million and were included in other long-term liabilities on our consolidated balance sheets.

Note 6 Stockholders Equity

Share Repurchases

During the three months ended September 30, 2007, we completed a tender offer pursuant to which we acquired 25 million tendered shares of our common stock at a purchase price of $29.00 per share, for a total cost of $725.0 million plus fees and expenses relating to the tender offer. We borrowed $500.0 million under our existing credit facility to fund a portion of the purchase price for the shares and used cash on-hand for the remainder of the purchase price and to pay related fees and expenses.

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Notes to Consolidated Financial Statements (Continued)

During the three months ended March 31, 2007, we completed a tender offer pursuant to which we acquired 30 million tendered shares of our common stock at a purchase price of $22.00 per share, for a total cost of $660.0 million plus fees and expenses relating to the tender offer. We funded the purchase price for the shares using cash-on hand.

Stock-based Awards

Stock-based compensation expense relates primarily to expense for stock options and restricted stock units (RSUs). Since February 2003, we have awarded RSUs as our primary form of employee stock-based compensation. Our stock-based awards generally vest over five years.

As of September 30, 2007, we had stock-based awards outstanding representing approximately 28.3 million shares of our common stock consisting of approximately 8.4 million RSUs and stock options to purchase approximately 19.9 million common shares with a weighted average exercise price of $16.66 and weighted average remaining life of 2.6 years.

Annual employee RSU grants typically occur during the first quarter of each year. During the nine months ended September 30, 2007, we granted 3.6 million RSUs. Net of cancellations, expirations and forfeitures occurring during this period, RSUs increased 2.3 million.

For the three and nine months ended September 30, 2007, stock-based compensation expense was $14.4 million and $44.2 million, consisting of $11.3 million and $33.6 million in expense primarily related to RSUs and $3.1 million and $10.6 million in stock option expense.

In October 2007, our Chairman and Senior Executive exercised 9.5 million options for a net delivery of shares of 3.7 million. Following this exercise, 10.4 million options, with a weighted average exercise price of $24.05 and a weighted average remaining life of 4.9 years, remained outstanding.

Comprehensive Income

Comprehensive income was $110.2 million and $66.0 million for the three months ended September 30, 2007 and 2006, and $245.4 million and $186.2 million for the nine months ended September 30, 2007 and 2006. The primary differences between net income as reported and comprehensive income were foreign currency translation adjustments and net gains (losses) on cross-currency hedge contracts.

Notes to Consolidated Financial Statements (Continued)

Note 7 Earnings Per Share

The following table presents our basic and diluted earnings per share:

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
	(in thousands, except per share data)			
Net income	$ 99,595	$ 58,977	$ 230,507	$ 177,794
Net earnings per share available to common stockholders:				
Basic	$ 0.34	$ 0.18	$ 0.77	$ 0.52
Diluted	0.32	0.17	0.72	0.50
Weighted average number of shares outstanding:				
Basic	292,171	330,359	300,959	340,660
Dilutive effect of:				
Options to purchase common stock	9,264	6,351	8,825	7,879
Warrants to purchase common stock	8,528	2,288	6,537	3,548
Other dilutive securities	2,793	2,139	2,527	2,988
Diluted	312,756	341,137	318,848	355,075

We have a two class share structure. The earnings per share amounts are the same for common stock and Class B common stock because the holders of each class are legally entitled to equal per share distributions whether through dividends or in liquidation.

Note 8 Other, net

The following table presents the components of other, net:

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
	(in thousands)			
Unrealized gain (loss) on derivative instruments, net	$ (1,394)	$ (603)	$ (5,938)	$ 11,609
Federal excise tax refunds			12,058	
Foreign exchange rate gains (losses), net	(12,265)	1,785	(15,450)	3,317
Equity in income (loss) of unconsolidated affiliates	(294)	1,745	(3,848)	2,331
Other	59	(1)	(275)	(208)
Total	$ (13,894)	$ 2,926	$ (13,453)	$ 17,049

Federal Excise Tax Refunds

During the second quarter of 2007, we recorded refunds based on notification from the Internal Revenue Service (IRS) totaling $14.7 million related to Federal Excise Tax (FET) taxes remitted to the IRS but not collected from customers for airline ticket sales by one of our subsidiaries in the third quarter of 2001 through the third quarter of 2004, plus accrued interest thereon. We recorded $2.6 million to revenue as that amount relates to taxes remitted on airline ticket sales

Notes to Consolidated Financial Statements (Continued)

subsequent to our acquisition of the subsidiary. We recorded $12.1 million to other, net for taxes remitted on airline ticket sales prior to the acquisition and total interest earned on all underlying tax remittances.

Note 9 Acquisitions and Other Investments

During the nine months ended September 30, 2007, we acquired all or part of four travel-related companies, one of which is accounted for under the equity method as our ownership interest is 50%. The purchase price of these and other acquisition related costs totaled $85.7 million, all of which we paid in cash. For the three acquisitions, we recorded $34.2 million in goodwill and $17.6 million of intangible assets with definite lives. The results of operations of each of the acquired businesses have been included in our consolidated results from each transaction closing date forward. The effect of these acquisitions on consolidated net revenue and operating income during the three and nine months ended September 30, 2007 was not significant. Based on the annual financial performance of one of the acquired companies during each of 2007 and 2008, we are obligated to pay an additional purchase price ranging from $0 to a maximum of approximately $100 million in total. The potential maximum additional amount may be achieved based on the annual results of 2007 or 2008, or the two periods combined, with funding of amounts based on 2007 performance expected in the first half of 2008 and for 2008 performance expected in the first half of 2009.

We have also entered into a commitment to provide the equity method investee a $10 million revolving operating line of credit and a credit facility for up to $20 million. As of the end of 2008, any amounts due under the credit facility are convertible, at our option, into shares of the company at a premium to the then fair market value. No amounts were drawn against either facility as of September 30, 2007.

Note 10 Commitments and Contingencies

Lease Commitments

We have contractual obligations in the form of operating leases for office space and related office equipment for which we record the related expense on a monthly basis. Certain leases contain periodic rent escalation adjustments and renewal options. Operating lease obligations expire at various dates with the latest maturity in 2018. In June 2007, we entered into a ten-year lease for approximately 348,000 square feet of office space located in Bellevue, Washington. We expect the term and cash payments related to this lease to begin in November 2008.

Our estimated future minimum rental payments under operating leases with noncancelable lease terms that expire after September 30, 2007 are $7.0 million for the remainder of 2007, $29.0 million for 2008, $28.7 million for 2009, $26.1 million for 2010, $24.8 million for 2011 and $116.7 million for 2012 and thereafter.

Legal Proceedings

In the ordinary course of business, we are a party to various lawsuits. In the opinion of management, we do not expect these lawsuits to have a material impact on the liquidity, results of operations or financial condition of Expedia. We also evaluate other potential contingent matters, including value-added tax, federal excise tax, transient occupancy or accommodation taxes and similar matters. We do not believe that the aggregate amount of liability that could be reasonably possible with respect to these matters would have a material adverse affect on our financial results.

Litigation Relating to Hotel Occupancy Taxes. Lawsuits have been filed by thirty-seven cities and counties involving hotel occupancy taxes. In addition, there have been five consumer lawsuits filed relating to taxes and fees. The municipality and consumer lawsuits are in various stages ranging from responding to the complaint to discovery. We continue to defend these lawsuits vigorously. To date, twelve of the municipality lawsuits have been dismissed. Most of these dismissals have been without prejudice and, generally, allow the municipality to seek administrative remedies prior to pursuing further litigation. One dismissal (Pitt County, North Carolina) was based on a finding that the defendants were not subject to the local hotel occupancy tax ordinance. As a result of this litigation and other attempts by certain jurisdictions to levy such taxes, we have established a reserve for the potential settlement of issues related to hotel

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Notes to Consolidated Financial Statements (Continued)

occupancy taxes in the amount of $18.8 million and $17.5 million at September 30, 2007 and December 31, 2006, respectively. Our reserve is based on our best estimates and the ultimate resolution of these issues may be greater or less than the liabilities recorded.

Note 11 Related Party Transactions

Commercial Agreements with IAC

Since the Spin-Off, we have continued to work with some of IAC s businesses pursuant to a variety of commercial agreements. These commercial agreements generally include (i) distribution agreements, pursuant to which certain subsidiaries of IAC distribute their respective products and services via arrangements with Expedia, and vice versa, (ii) services agreements, pursuant to which certain subsidiaries of IAC provide Expedia with various services and vice versa and (iii) office space lease agreements. The distribution agreements typically involve the payment of fees, usually on a fixed amount-per-transaction, revenue share or commission basis, from the party seeking distribution of the product or service to the party that is providing the distribution. Net operating expenses related to these transactions were less than $4 million during the nine months ended September 30, 2007.

Note 12 Segment Information

We have two reportable segments: North America and Europe. We determined our segments based on how our chief operating decision makers manage our business, make operating decisions and evaluate operating performance. Our primary operating metric for evaluating segment performance is Operating Income Before Amortization (defined below), which includes allocations of certain expenses, primarily cost of revenue and facilities, to the segments. We base the allocations primarily on transaction volumes and other usage metrics; this methodology is periodically evaluated and may change. We do not allocate certain shared expenses to reportable segments such as partner services, product development, accounting, human resources and legal. We include these expenses in Corporate and Other.

Our North America segment provides a full range of travel services to customers in the United States, Canada and Mexico. This segment operates through a variety of brands including Classic Vacations, Expedia.com, Hotels.com, Hotwire.com and TripAdvisor. Our Europe segment provides travel services primarily through localized Expedia websites in Austria, Denmark, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden and the United Kingdom, as well as localized versions of Hotels.com in various European countries.

Corporate and Other includes ECT, Expedia Asia Pacific and unallocated corporate functions and expenses. ECT provides travel products and services to corporate customers in North America and Europe. Expedia Asia Pacific provides online travel information and reservation services primarily through eLong in the People s Republic of China, localized Expedia websites in Australia, Japan and New Zealand, as well as localized versions of Hotels.com in various Asian countries. In addition, we record amortization of intangible assets and any related impairment, as well as stock-based compensation expense in Corporate and Other.

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Notes to Consolidated Financial Statements (Continued)

The following table presents our segment information for the three and nine months ended September 30, 2007 and 2006. As a significant portion of our property and equipment is not allocated to our operating segments, we do not report the assets or related depreciation expense as it would not be meaningful, nor do we regularly provide such information to our chief operating decision makers.

	Three months ended September 30, 2007			
	North America	Europe	Corporate and Other	Total
	(in thousands)			
Revenue	$ 534,453	$ 182,899	$ 42,244	$ 759,596
Operating Income Before Amortization	$ 238,555	$ 68,472	$ (94,225)	$ 212,802
Amortization of intangible assets			(18,613)	(18,613)
Stock-based compensation			(14,417)	(14,417)
Operating income (loss)	$ 238,555	$ 68,472	$ (127,255)	$ 179,772

	Three months ended September 30, 2006			
	North America	Europe	Corporate and Other	Total
	(in thousands)			
Revenue	$ 450,294	$ 133,780	$ 29,868	$ 613,942
Operating Income Before Amortization	$ 203,932	$ 47,895	$ (71,816)	$ 180,011
Amortization of intangible assets			(26,569)	(26,569)
Stock-based compensation			(16,439)	(16,439)
Amortization of non-cash distribution and marketing	(711)			(711)
Impairment of intangible asset			(47,000)	(47,000)
Operating income (loss)	$ 203,221	$ 47,895	$ (161,824)	$ 89,292

	Nine months ended September 30, 2007			
	North America	Europe	Corporate and Other	Total
	(in thousands)			

Revenue	$ 1,446,233	$ 438,326	$ 115,471	$ 2,000,030
Operating Income Before Amortization	$ 629,366	$ 137,097	$ (262,171)	$ 504,292
Amortization of intangible assets			(59,312)	(59,312)
Stock-based compensation			(44,249)	(44,249)
Operating income (loss)	$ 629,366	$ 137,097	$ (365,732)	$ 400,731

	Nine months ended September 30, 2006			
	North America	Europe	Corporate and Other	Total
	(in thousands)			
Revenue	$ 1,288,144	$ 331,084	$ 87,070	$ 1,706,298
Operating Income Before Amortization	$ 563,216	$ 103,065	$ (213,507)	$ 452,774
Amortization of intangible assets			(86,860)	(86,860)
Stock-based compensation			(57,547)	(57,547)
Amortization of non-cash distribution and marketing	(9,578)			(9,578)
Impairment of intangible asset			(47,000)	(47,000)
Operating income (loss)	$ 553,638	$ 103,065	$ (404,914)	$ 251,789

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Notes to Consolidated Financial Statements (Continued)

We have revised certain 2006 revenue and expense allocations between our segments to reflect current allocations for certain points of sale. There was no impact on total consolidated revenue or operating income before amortization as a result of these changes.

Definition of Operating Income Before Amortization (OIBA)

We provide OIBA as a supplemental measure to GAAP. We define OIBA as operating income plus: (1) amortization of non-cash distribution and marketing expense, (2) stock-based compensation expense, (3) amortization of intangible assets and goodwill and intangible asset impairment, if applicable and (4) certain one-time items, if applicable.

OIBA is the primary operating metric used by which management evaluates the performance of our business, on which internal budgets are based, and by which management is compensated. Management believes that investors should have access to the same set of tools that management uses to analyze our results. This non-GAAP measure should be considered in addition to results prepared in accordance with GAAP, but should not be considered a substitute for, or superior to, GAAP. We endeavor to compensate for the limitation of the non-GAAP measure presented by also providing the comparable GAAP measures, GAAP financial statements, and descriptions of the reconciling items and adjustments, to derive the non-GAAP measure. We present a reconciliation of this non-GAAP financial measure to GAAP below.

OIBA represents the combined operating results of Expedia, Inc. s businesses, taking into account depreciation, which we believe is an ongoing cost of doing business, but excluding the effects of other non-cash expenses that may not be indicative of our core business operations. We believe this measure is useful to investors for the following reasons:

- It corresponds more closely to the cash operating income generated from our core operations by excluding significant non-cash operating expenses, such as stock-based compensation; and

- It provides greater insight into management decision making at Expedia, as OIBA is our primary internal metric for evaluating the performance of our business.

OIBA has certain limitations in that it does not take into account the impact of certain expenses to our consolidated statements of income, including stock-based compensation, non-cash payments to partners, acquisition-related accounting and certain one-time items, if applicable. Due to the high variability and difficulty in predicting certain items that affect net income, such as tax rates, stock price and interest rates, we are unable to provide a reconciliation to net income on a forward-looking basis without unreasonable efforts.

Reconciliation of OIBA to Operating Income and Net Income

The following table presents a reconciliation of OIBA to operating income and net income for the three and nine months ended September 30, 2007 and 2006:

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
	(in thousands)			
OIBA	$ 212,802	$ 180,011	$ 504,292	$ 452,774
Amortization of intangible assets	(18,613)	(26,569)	(59,312)	(86,860)
Impairment of intangible asset		(47,000)		(47,000)
Stock-based compensation	(14,417)	(16,439)	(44,249)	(57,547)
Amortization of non-cash distribution and marketing		(711)		(9,578)
Operating income	179,772	89,292	400,731	251,789
Interest income (expense), net	(1,052)	4,840	(4,309)	13,102

Other, net	(13,894)	2,926	(13,453)	17,049
Provision for income taxes	(65,542)	(37,707)	(153,230)	(103,523)
Minority interest in (income) loss of consolidated subsidiaries, net	311	(374)	768	(623)
Net income	$ 99,595	$ 58,977	$ 230,507	$ 177,794

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Notes to Consolidated Financial Statements (Continued)

NOTE 13 Guarantor and Non-Guarantor Supplemental Financial Information

Condensed consolidating financial information of Expedia, Inc. (the Parent), our subsidiaries that are guarantors of the Notes (the Guarantor Subsidiaries), and our subsidiaries that are not guarantors of the Notes (the Non-Guarantor Subsidiaries) is shown below. The Notes are guaranteed by certain of our wholly-owned domestic subsidiaries and rank equally in right of payment with all of our existing and future unsecured and unsubordinated obligations. The guarantees are full, unconditional, joint and several. In this financial information, the Parent and Guarantor Subsidiaries account for investments in their wholly-owned subsidiaries using the equity method.

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Notes to Consolidated Financial Statements (Continued)
CONDENSED CONSOLIDATING STATEMENT OF INCOME
Three Months Ended September 30, 2007
(in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenue	$	$ 698,833	$ 164,897	$ (104,134)	$ 759,596
Cost of revenue		128,794	23,595	(1,336)	151,053
Gross profit		570,039	141,302	(102,798)	608,543
Operating expenses:					
Selling and marketing		283,589	98,587	(102,835)	279,341
General and administrative		63,089	20,260	16	83,365
Technology and content		37,131	10,300	21	47,452
Amortization of intangible assets		16,627	1,986		18,613
Operating income		169,603	10,169		179,772
Other income (expense):					
Equity in pre-tax earnings of consolidated subsidiaries	113,269	11,071		(124,340)	
Other, net	(15,250)	(3,611)	3,915		(14,946)
Total other income, net	98,019	7,460	3,915	(124,340)	(14,946)
Income before income taxes and minority interest	98,019	177,063	14,084	(124,340)	164,826
Provision for income taxes	1,576	(62,774)	(4,344)		(65,542)
Minority interest in loss of consolidated subsidiaries, net			311		311
Net income	$ 99,595	$ 114,289	$ 10,051	$ (124,340)	$ 99,595

CONDENSED CONSOLIDATING STATEMENT OF INCOME
Three Months Ended September 30, 2006
(in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenue	$	$ 573,816	$ 114,450	$ (74,324)	$ 613,942
Cost of revenue		114,125	19,815	(846)	133,094
Gross profit		459,691	94,635	(73,478)	480,848
Operating expenses:					
Selling and marketing		213,732	74,647	(73,293)	215,086

General and administrative		53,206	13,135	(185)	66,156
Technology and content		28,118	7,916		36,034
Amortization of intangible assets		24,862	1,707		26,569
Impairment of intangible asset		47,000			47,000
Amortization of non-cash distribution and marketing		711			711
Operating income (loss)		92,062	(2,770)		89,292
Other income (expense):					
Equity in pre-tax earnings (losses) of consolidated subsidiaries	62,678	(437)		(62,241)	
Other, net	(5,460)	11,488	1,738		7,766
Total other income, net	57,218	11,051	1,738	(62,241)	7,766
Income (loss) before income taxes and minority interest	57,218	103,113	(1,032)	(62,241)	97,058
Provision for income taxes	1,759	(39,437)	(29)		(37,707)
Minority interest in income of consolidated subsidiaries, net			(374)		(374)
Net income (loss)	$ 58,977	$ 63,676	$ (1,435)	$ (62,241)	$ 58,977

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Notes to Consolidated Financial Statements (Continued)
CONDENSED CONSOLIDATING STATEMENT OF INCOME
Nine Months Ended September 30, 2007
(in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenue	$	$ 1,833,268	$ 442,338	$ (275,576)	$ 2,000,030
Cost of revenue		350,051	69,736	(3,790)	415,997
Gross profit		1,483,217	372,602	(271,786)	1,584,033
Operating expenses:					
Selling and marketing		755,384	274,078	(271,948)	757,514
General and administrative		179,754	55,305	202	235,261
Technology and content		102,214	29,041	(40)	131,215
Amortization of intangible assets		53,582	5,730		59,312
Operating income		392,283	8,448		400,731
Other income (expense):					
Equity in pre-tax earnings of consolidated subsidiaries	269,397	10,081		(279,478)	
Other, net	(41,226)	19,350	4,105	9	(17,762)
Total other income, net	228,171	29,431	4,105	(279,469)	(17,762)
Income before income taxes and minority interest	228,171	421,714	12,553	(279,469)	382,969
Provision for income taxes	2,336	(149,940)	(5,626)		(153,230)
Minority interest in loss of consolidated subsidiaries, net			768		768
Net income	$ 230,507	$ 271,774	$ 7,695	$ (279,469)	$ 230,507

CONDENSED CONSOLIDATING STATEMENT OF INCOME
Nine Months Ended September 30, 2006
(in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenue	$	$ 1,587,359	$ 323,290	$ (204,351)	$ 1,706,298
Cost of revenue		325,964	57,929	(3,036)	380,857
Gross profit		1,261,395	265,361	(201,315)	1,325,441
Operating expenses:					
Selling and marketing		616,342	199,620	(201,184)	614,778
General and administrative		171,059	39,642	(131)	210,570

Technology and content		81,824	23,042		104,866
Amortization of intangible assets		81,375	5,485		86,860
Impairment of intangible asset		47,000			47,000
Amortization of non-cash distribution and marketing		9,578			9,578
Operating income (loss)		254,217	(2,428)		251,789
Other income (expense):					
Equity in earnings of consolidated subsidiaries	170,797	1,739		(172,536)	
Other, net	4,379	23,736	2,036		30,151
Total other income, net	175,176	25,475	2,036	(172,536)	30,151
Income (loss) before income taxes and minority interest	175,176	279,692	(392		