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

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2012**

**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**

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**Sohu.com Inc.**

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

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**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)

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

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

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

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

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

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

<u>Class</u>	<u>Outstanding at September 30, 2012</u>
Common stock, \$.001 par value	38,031,318

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SOHU.COM INC.

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**PART I – FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SOHU.COM INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**  
(In thousands, except par value)

	As of	
	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 773,469	\$ 732,607
Restricted time deposits	115,124	0
Short-term investments	41,930	17,560
Investments in debt securities	78,852	79,354
Accounts receivable, net	98,090	87,066
Prepaid and other current assets	44,969	53,894
Total current assets	<u>1,152,434</u>	<u>970,481</u>
Fixed assets, net	170,415	152,652
Goodwill	158,104	158,905
Intangible assets, net	79,774	69,762
Restricted time deposits	110,633	0
Prepaid non-current assets	268,002	270,282
Other assets	11,323	11,212
Total assets	<u>\$ 1,950,685</u>	<u>\$1,633,294</u>
<b>LIABILITIES</b>		
Current liabilities:		
Accounts payable	\$ 58,918	\$ 31,179
Accrued liabilities	103,076	95,409
Receipts in advance and deferred revenue	80,177	75,809
Accrued salary and benefits	55,738	45,300
Taxes payable	34,768	47,213
Deferred tax liabilities	8,701	0
Short-term bank loans	113,000	0
Other short-term liabilities	56,176	35,816
Contingent consideration	76	476
Total current liabilities	<u>510,630</u>	<u>331,202</u>
Long-term accounts payable	15,042	3,612
Long-term bank loans	109,353	0
Deferred tax liabilities	8,096	5,146
Contingent consideration	0	17,009
Total long-term liabilities	<u>132,491</u>	<u>25,767</u>
Total liabilities	<u>643,121</u>	<u>356,969</u>
Commitments and contingencies		
<b>MEZZANINE EQUITY</b>	56,895	57,254
<b>SHAREHOLDERS' EQUITY</b>		
Sohu.com Inc. shareholders' equity:		
Common stock: \$0.001 par value per share (75,400 shares authorized; 38,031 shares and 38,082 shares, respectively, issued and outstanding)	44	44
Additional paid-in capital	359,926	366,210
Treasury stock (5,889 and 5,639 shares, respectively)	(143,858)	(131,292)
Accumulated other comprehensive income	70,212	76,219
Retained earnings	759,015	697,244
Total Sohu.com Inc. shareholders' equity	<u>1,045,339</u>	<u>1,008,425</u>
Noncontrolling interest	205,330	210,646
Total shareholders' equity	<u>1,250,669</u>	<u>1,219,071</u>
Total liabilities, mezzanine equity and shareholders' equity	<u>\$ 1,950,685</u>	<u>\$1,633,294</u>

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Revenues:</b>				
Online advertising:				
Brand advertising	\$ 77,874	\$ 76,572	\$208,154	\$201,453
Search and others	35,284	18,410	85,684	40,002
Subtotal of online advertising revenues	<u>113,158</u>	<u>94,982</u>	<u>293,838</u>	<u>241,455</u>
Online games	151,093	115,798	415,711	312,259
Wireless	14,312	14,210	43,261	37,559
Others	6,815	7,870	14,899	14,661
Total revenues	<u>285,378</u>	<u>232,860</u>	<u>767,709</u>	<u>605,934</u>
<b>Cost of revenues:</b>				
Online advertising:				
Brand advertising	37,476	30,221	125,331	76,942
Search and others	19,736	9,478	49,056	24,365
Subtotal of cost of online advertising revenues	<u>57,212</u>	<u>39,699</u>	<u>174,387</u>	<u>101,307</u>
Online games	21,026	14,578	55,735	33,496
Wireless	9,474	8,727	28,535	22,728
Others	9,037	4,469	17,458	11,359
Total cost of revenues	<u>96,749</u>	<u>67,473</u>	<u>276,115</u>	<u>168,890</u>
Gross profit	<u>188,629</u>	<u>165,387</u>	<u>491,594</u>	<u>437,044</u>
<b>Operating expenses:</b>				
Product development	46,994	28,943	128,927	78,005
Sales and marketing	58,250	47,150	145,903	112,275
General and administrative	19,666	15,686	54,968	41,000
Impairment of intangible assets via acquisition of businesses	0	0	2,906	0
Total operating expenses	<u>124,910</u>	<u>91,779</u>	<u>332,704</u>	<u>231,280</u>
Operating profit	<u>63,719</u>	<u>73,608</u>	<u>158,890</u>	<u>205,764</u>
Other income	(111)	3,249	3,320	5,238
Interest income	5,974	4,314	19,692	10,312
Exchange difference	667	(2,420)	69	(4,504)
Income before income tax expense	<u>70,249</u>	<u>78,751</u>	<u>181,971</u>	<u>216,810</u>
Income tax expense	<u>18,727</u>	<u>14,441</u>	<u>55,881</u>	<u>35,724</u>
Net income	<u>51,522</u>	<u>64,310</u>	<u>126,090</u>	<u>181,086</u>
Less: Net income attributable to the mezzanine classified noncontrolling interest shareholders	4,495	1,092	6,701	1,453
Net income attributable to the noncontrolling interest shareholders	<u>21,146</u>	<u>16,406</u>	<u>57,618</u>	<u>43,748</u>
Net income attributable to Sohu.com Inc.	<u>\$ 25,881</u>	<u>\$ 46,812</u>	<u>\$ 61,771</u>	<u>\$135,885</u>
Net income	51,522	64,310	126,090	181,086
Other comprehensive income: Foreign currency translation adjustment, net of tax	(3,447)	16,586	(7,115)	34,646
Comprehensive income	<u>48,075</u>	<u>80,896</u>	<u>118,975</u>	<u>215,732</u>
Less: Comprehensive income attributable to the mezzanine classified noncontrolling interest	4,495	1,092	6,701	1,453
Comprehensive income attributable to noncontrolling interest shareholders	<u>20,540</u>	<u>18,801</u>	<u>56,510</u>	<u>48,172</u>
Comprehensive income attributable to Sohu.com Inc.	<u>23,040</u>	<u>61,003</u>	<u>55,764</u>	<u>166,107</u>
Basic net income per share attributable to Sohu.com Inc.	<u>\$ 0.68</u>	<u>\$ 1.22</u>	<u>\$ 1.63</u>	<u>\$ 3.55</u>
Shares used in computing basic net income per share attributable to Sohu.com Inc.	<u>38,022</u>	<u>38,298</u>	<u>38,036</u>	<u>38,262</u>
Diluted net income per share attributable to Sohu.com Inc.	<u>\$ 0.63</u>	<u>\$ 1.17</u>	<u>\$ 1.44</u>	<u>\$ 3.28</u>
Shares used in computing diluted net income per share attributable to Sohu.com Inc.	<u>38,344</u>	<u>38,844</u>	<u>38,392</u>	<u>38,824</u>

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)

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 126,090	\$ 181,086
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	28,137	19,143
Share-based compensation expense	10,202	14,061
Amortization of intangible assets	48,541	26,342
Impairment of intangible assets	7,522	233
Impairment of purchased video content	15,101	0
Provision for allowance for doubtful accounts	3,538	911
Excess tax benefits from share-based payment arrangements	(3,492)	(1,401)
Investment income of investments in debt securities	(4,098)	(2,207)
Others	89	(1,066)
Changes in assets and liabilities, net of acquisition:		
Accounts receivable	(15,025)	(22,957)
Prepaid and other current assets	2,321	1,699
Deferred tax	7,595	(300)
Accounts payable	16,124	5,418
Taxes payable	(5,010)	365
Accrued liabilities	19,165	22,177
Receipts in advance and deferred revenue	4,809	10,833
Other short-term liabilities	18,172	2,154
Net cash provided by operating activities	279,781	256,491
Cash flows from investing activities:		
Purchase of fixed assets	(50,840)	(84,130)
Purchase of intangible and other assets	(44,048)	(45,936)
Cash paid relating to restricted time deposits	(225,757)	0
Purchase of /proceeds from short-term investments, net	(24,436)	(4,393)
Acquisitions, net of cash acquired	(683)	(71,129)
Other cash payments relating to investing activities	(979)	(4,348)
Net cash used in investing activities	(346,743)	(209,936)
Cash flows from financing activities:		
Issuance of common stock	240	1,507
Sohu's purchase of Sogou Series A Preferred Shares from Alibaba	(25,800)	0
Repurchase of common stock	(12,566)	(16,601)
Purchase of shares in subsidiary	0	(25,675)
Portion of Changyou dividend distribute to noncontrolling interest shareholders	(64,551)	0
Purchase of offshore bridge loans from banks	222,353	0
Cash contribution received from the noncontrolling interest shareholders	0	159
Payment of contingent consideration	(13,806)	0
Excess tax benefits from share-based payment arrangements	3,492	1,401
Exercise of share-based awards in subsidiary	1,352	0
Other cash payments relating to financing activities	(281)	0
Net cash provided by /used in financing activities	110,433	(39,209)
Effect of exchange rate changes on cash and cash equivalents	(2,609)	21,688
Net increase in cash and cash equivalents	40,862	29,034
Cash and cash equivalents at beginning of period	732,607	678,389
Cash and cash equivalents at end of period	<u>\$ 773,469</u>	<u>\$ 707,423</u>
Supplemental schedule of non-cash investing activity:		
Consideration payable for business acquisitions	0	32,066

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

**SOHU.COM INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (unaudited)**

**Nine Months Ended September 30, 2012**  
(In thousands)

	Sohu.com Inc. Shareholders' Equity						
	Total	Common Stock	Additional Paid-in Capital	Treasury Stock	Accumulated Other Comprehensive Income	Retained Earnings	Noncontrolling Interest
Beginning balance	\$1,219,071	\$ 44	\$366,210	\$(131,292)	\$ 76,219	\$697,244	\$ 210,646
Issuance of common stock	240	0	240	0	0	0	0
Repurchase of common stock	(12,566)	0	0	(12,566)	0	0	0
Share-based compensation expense	10,202	0	4,555	0	0	0	5,647
Settlement of share-based awards in subsidiary	1,353	0	(7,477)	0	0	0	8,830
Portion of Changyou dividend attributable to noncontrolling interest shareholders	(64,551)	0	0	0	0	0	(64,551)
Sohu's purchase of Sogou Series A Preferred Shares from Alibaba	(25,800)	0	(14,219)	0	0	0	(11,581)
Changes in mezzanine equity of Changyou	6,836	0	6,836	0	0	0	0
Transaction cost for the sale of the 17173 Business from Sohu to Changyou	118	0	118	0	0	0	0
Deemed contribution from noncontrolling shareholders (related to sale of the 17173 Business by Sohu to Changyou)	0	0	171	0	0	0	(171)
Excess tax benefits from share-based awards	3,492	0	3,492	0	0	0	0
Net income attributable to Sohu.com Inc. and noncontrolling interest shareholders	119,389	0	0	0	0	61,771	57,618
Foreign currency translation adjustment, net of tax	(7,115)	0	0	0	(6,007)	0	(1,108)
Ending balance	<u>\$1,250,669</u>	<u>\$ 44</u>	<u>\$359,926</u>	<u>\$(143,858)</u>	<u>\$ 70,212</u>	<u>\$759,015</u>	<u>\$ 205,330</u>

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

**SOHU.COM INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (unaudited)**

**Nine Months Ended September 30, 2011**  
(In thousands)

	<u>Sohu.com Inc. Shareholders' Equity</u>						
	<u>Total</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Treasury Stock</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Retained Earnings</u>	<u>Noncontrolling Interest</u>
Beginning balance	\$ 974,559	\$ 43	\$338,033	\$(114,690)	\$ 38,228	\$534,503	\$ 178,442
Issuance of common stock	1,507	1	1,506	0	0	0	0
Contribution received from the noncontrolling interest shareholders	159	0	0	0	0	0	159
Repurchase of common stock	(16,602)	0	0	(16,602)	0	0	0
Purchase of shares in subsidiary	(25,675)	0	(17,132)	0	0	0	(8,543)
Share-based compensation expense	14,061	0	8,675	0	0	0	5,386
Settlement of share-based awards in subsidiary	0	0	(6,800)	0	0	0	6,800
Excess tax benefits from share-based awards	1,401	0	1,401	0	0	0	0
Net income attributable to Sohu.com Inc. and noncontrolling interest shareholders	179,633	0	0	0	0	135,885	43,748
Foreign currency translation adjustment, net of tax	34,646	0	0	0	30,222	0	4,424
Ending balance	<u>\$1,163,689</u>	<u>\$ 44</u>	<u>\$325,683</u>	<u>\$(131,292)</u>	<u>\$ 68,450</u>	<u>\$670,388</u>	<u>\$ 230,416</u>

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**

***Nature of Operations***

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

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

***Online Advertising***

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

***Online Games***

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

The online game business consists of development, operation and licensing of massively multiplayer online games (“MMOGs”), which are interactive online games that may be played simultaneously by hundreds of thousands of game players, and Web games, which are played over the Internet using a Web browser. Changyou currently operates several MMOGs in China, including the in-house developed Tian Long Ba Bu (“TLBB”). Changyou’s majority-owned subsidiary 7Road.com Limited (“7Road”) jointly operates DDTank and Wartune (also known as “Shen Qu”), which are two popular Web games in China, primarily through an extensive network of third-party game platforms in China and overseas.

***Basis of Consolidation and Recognition of Noncontrolling Interest***

The consolidated financial statements include the accounts of Sohu and its wholly-owned and majority-owned subsidiaries and variable interest entities (“VIEs”). All intercompany transactions are eliminated.

The consolidation of VIEs is one of the Company’s critical accounting policies. The Company has adopted the guidance of accounting for VIEs, which requires VIEs to be consolidated by the primary beneficiary of the entity. The Company’s management made evaluations of the relationships between the Company and its VIEs and the economic benefit flow of contractual arrangements with the VIEs. In connection with such evaluation, management also took into account the fact that, as a result of such contractual arrangements, the Sohu Group controls the shareholders’ voting interests in the VIEs. As a result of such evaluation, management concluded that the Sohu Group is the primary beneficiary of its VIEs. As a result, the Company consolidates all of its VIEs in its consolidated financial statements. Please refer to Note - 10 VIEs for more details.

For majority-owned subsidiaries and VIEs, noncontrolling interest is recognized to reflect the portion of their equity which is not attributable, directly or indirectly, to the controlling shareholder.

***Basis of Presentation***

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These financial statements should be read in conjunction with the consolidated financial statements and related footnotes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

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 nine months ended September 30, 2012 are not necessarily indicative of the results expected for the full fiscal year or for any future period. Certain comparative figures have been reclassified to conform to the current presentation.

***Change in Presentation to Properly Reflect the Classification of Expenses of Video Business***

Prior to 2012, the video division was a relatively small operation within the Sohu Group. It did not have clearly defined business departments and it was highly dependent on the Sohu Group’s resources to sustain its operation. The video division’s compensation and benefits expenses were recorded under cost of revenues and were not allocated to individual operating expense categories, in view of the fact that most of the employees in the video division provided services related to the maintenance of content and resources that directly contributed to video-related brand advertising revenues.



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Commencing January 1, 2012, as the video division has grown significantly and business departments have been defined through the restructuring process to become more self-sustainable, compensation and benefits expenses have been allocated to the respective business departments to properly reflect the operating results of the video division. The video division's compensation and benefits expenses were classified as cost of revenues, product development, sales and marketing and general and administrative expenses, respectively, based on the nature of the related employees' roles and responsibilities. To conform to current period presentations, the relevant amounts for prior periods have been changed accordingly. The change from cost of revenues to operating expenses was not material to historical periods, and amounted to \$1.4 million and \$2.9 million, respectively, for the three and nine months ended September 30, 2011.

### *Reclassification of Expenses of Search and Others Business*

To expand distribution of customers' sponsored links or advertisements, the search and others business acquires traffic from third-party Websites. Most traffic acquisition payments are made to Sogou's Website Alliance members. Payments to Sogou's Website Alliance members are based on a portion of pay-for-click revenues generated from clicks by users of their properties, and are included in cost of search and others revenues. A relatively small portion of traffic acquisition payments to third-party Websites are based on pre-agreed unit prices and the actual traffic volume they direct to the search and others business. Prior to 2012, traffic acquisition payments based on pre-agreed unit price and the actual traffic volume were recorded in sales and marketing expenses.

Commencing January 1, 2012, in order to enhance comparability with industry peers, all traffic acquisition costs were recorded in cost of revenues. To conform to current period presentations, the relevant amounts for prior periods have been reclassified accordingly. Such reclassifications amounted to \$2.0 million and \$5.9 million, respectively, for the three and nine months ended September 30, 2011.

## **2. Segment Information**

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

Beginning with the second quarter of 2011, to better reflect management's perspective and match the segment with the entity, the Company changed the segment names of sponsored search and game to Sogou and Changyou, respectively.

In December 2011, the Company sold the 17173 Business to Changyou. Beginning January 1, 2012, the Company began to review the 17173 Business as part of the Changyou segment and changed the Company's segment operating performance measurements by transferring the 17173 Business from the brand advertising segment to the Changyou segment. The comparative operating results of the brand advertising segment and the Changyou segment were retrospectively restated.

Some items, such as share-based compensation expense, operating expenses, other income and expense, and income tax expense, are not reviewed by the CODM. These items are disclosed in the segment information for reconciliation purposes only. The Company has restated the presentation of its segments for prior periods to conform to the current presentation, and it will restate all comparable periods hereafter.

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

Three Months Ended September 30, 2012								
Brand Advertising, Wireless and Others								
	Brand Advertising	Wireless	Others	Brand Advertising, Wireless and Others	Sogou	Changyou	Eliminations	Consolidated
Revenues (1)	\$ 68,217	\$14,312	\$2,935	\$ 85,464	\$ 37,295	\$165,782	\$ (3,163)	\$ 285,378
Segment cost of revenues	(35,620)	(9,474)	(841)	(45,935)	(19,715)	(30,908)	41	(96,517)
Segment gross profit /(loss)	<u>\$ 32,597</u>	<u>\$ 4,838</u>	<u>\$2,094</u>	39,529	17,580	134,874	(3,122)	188,861
SBC (2) in cost of revenues				(133)	(21)	(78)	0	(232)
Gross profit				39,396	17,559	134,796	(3,122)	188,629
Operating expenses:								
Product development				(16,916)	(11,034)	(17,728)	0	(45,678)
Sales and marketing				(36,744)	(7,693)	(16,353)	3,122	(57,668)
General and administrative				(8,842)	(1,524)	(7,587)	0	(17,953)
SBC (2) in operating expenses				(1,030)	(1,931)	(715)	65	(3,611)
Total operating expenses				(63,532)	(22,182)	(42,383)	3,187	(124,910)
Operating profit /(loss)				(24,136)	(4,623)	92,413	65	63,719
Other income /(expense) (3)				137,940	61	(1,787)	(136,325)	(111)
Interest income				2,297	73	3,604	0	5,974
Exchange difference				88	31	548	0	667
Income /(loss) before income tax expense				116,189	(4,458)	94,778	(136,260)	70,249
Income tax expense				(1,373)	0	(17,354)	0	(18,727)
Net income				<u>\$ 114,816</u>	<u>\$ (4,458)</u>	<u>\$ 77,424</u>	<u>\$ (136,260)</u>	<u>\$ 51,522</u>

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

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

Note (3): The elimination for other income is primarily for the portion payable by Changyou to Sohu of a special one-time cash dividend paid by Changyou to its shareholders. See Note 4 - Changyou Distribution of Cash Dividend.

Three Months Ended September 30, 2011								
Brand Advertising, Wireless and Others								
	Brand Advertising	Wireless	Others	Brand Advertising, Wireless and Others	Sogou	Changyou	Eliminations	Consolidated
Revenues (1)	\$ 68,075	\$14,210	\$ 4,655	\$ 86,940	\$ 18,814	\$128,697	\$ (1,591)	\$ 232,860
Segment cost of revenues	(29,098)	(8,727)	(1,009)	(38,834)	(9,478)	(19,024)	116	(67,220)
Segment gross profit /(loss)	<u>\$ 38,977</u>	<u>\$ 5,483</u>	<u>\$ 3,646</u>	48,106	9,336	109,673	(1,475)	165,640
SBC (2) in cost of revenues				(201)	0	(52)	0	(253)
Gross profit				47,905	9,336	109,621	(1,475)	165,387
Operating expenses:								
Product development				(10,207)	(4,976)	(12,127)	0	(27,310)
Sales and marketing				(27,219)	(3,114)	(17,418)	1,475	(46,276)
General and administrative				(6,074)	(924)	(7,071)	0	(14,069)
SBC (2) in operating expenses				(1,829)	(1,202)	(1,246)	153	(4,124)
Total operating expenses				(45,329)	(10,216)	(37,862)	1,628	(91,779)
Operating profit /(loss)				2,576	(880)	71,759	153	73,608
Other income				2,106	2	1,141	0	3,249
Interest income				875	35	3,404	0	4,314
Exchange difference				(1,753)	(507)	(160)	0	(2,420)
Income /(loss) before income tax expense				3,804	(1,350)	76,144	153	78,751
Income tax expense				(1,278)	0	(13,163)	0	(14,441)
Net income				<u>\$ 2,526</u>	<u>\$ (1,350)</u>	<u>\$ 62,981</u>	<u>\$ 153</u>	<u>\$ 64,310</u>

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

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

Nine Months Ended September 30, 2012								
Brand Advertising, Wireless and Others								
	Brand Advertising	Wireless	Others	Brand Advertising, Wireless and Others	Sogou	Changyou	Eliminations	Consolidated
Revenues (1)	\$ 188,117	\$ 43,261	\$ 6,210	\$ 237,588	\$ 90,470	\$ 449,888	\$ (10,237)	\$ 767,709
Segment cost of revenues	(120,915)	(28,535)	(1,770)	(151,220)	(48,992)	(75,700)	223	(275,689)
Segment gross profit /(loss)	<u>\$ 67,202</u>	<u>\$ 14,726</u>	<u>\$ 4,440</u>	86,368	41,478	374,188	(10,014)	492,020
SBC (2) in cost of revenues				(117)	(64)	(245)	0	(426)
Gross profit				<u>86,251</u>	<u>41,414</u>	<u>373,943</u>	<u>(10,014)</u>	<u>491,594</u>
Operating expenses:								
Product development				(46,400)	(27,911)	(50,597)	0	(124,908)
Sales and marketing				(95,522)	(18,277)	(40,505)	10,014	(144,290)
General and administrative				(23,543)	(4,235)	(23,046)	0	(50,824)
Impairment of intangible assets via acquisition of businesses				0	0	(2,906)	0	(2,906)
SBC (2) in operating expenses				(3,538)	(3,519)	(2,784)	65	(9,776)
Total operating expenses				<u>(169,003)</u>	<u>(53,942)</u>	<u>(119,838)</u>	<u>10,079</u>	<u>(332,704)</u>
Operating profit /(loss)				(82,752)	(12,528)	254,105	65	158,890
Other income /(expense) (3)				140,495	60	(910)	(136,325)	3,320
Interest income				8,812	261	10,619	0	19,692
Exchange difference				188	58	(177)	0	69
Income /(loss) before income tax expense				66,743	(12,149)	263,637	(136,260)	181,971
Income tax expense				(6,187)	0	(49,694)	0	(55,881)
Net income				<u>\$ 60,556</u>	<u>\$ (12,149)</u>	<u>\$ 213,943</u>	<u>\$ (136,260)</u>	<u>\$ 126,090</u>

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

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

Note (3): The elimination for other income is primarily for the portion payable by Changyou to Sohu of a special one-time cash dividend paid by Changyou to its shareholders. See Note 4 - Changyou Distribution of Cash Dividend.

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Nine Months Ended September 30, 2011

	Brand Advertising, Wireless and Others				Sogou	Changyou	Eliminations	Consolidated
	Brand Advertising	Wireless	Others	Brand Advertising, Wireless and Others				
Revenues (1)	\$178,745	\$ 37,559	\$ 5,793	\$ 222,097	\$ 40,664	\$346,925	\$ (3,752)	\$ 605,934
Segment cost of revenues	(73,076)	(22,728)	(1,165)	(96,969)	(24,365)	(46,343)	330	(167,347)
Segment gross profit/(loss)	<u>\$105,669</u>	<u>\$ 14,831</u>	<u>\$ 4,628</u>	125,128	16,299	300,582	(3,422)	438,587
SBC (2) in cost of revenues				(1,373)	0	(170)	0	(1,543)
Gross profit				<u>123,755</u>	<u>16,299</u>	<u>300,412</u>	<u>(3,422)</u>	<u>437,044</u>
Operating expenses:								
Product development				(25,663)	(13,015)	(34,501)	0	(73,179)
Sales and marketing				(67,784)	(8,382)	(36,696)	3,422	(109,440)
General and administrative				(15,501)	(2,792)	(17,850)	0	(36,143)
SBC (2) in operating expenses				(5,307)	(2,892)	(4,485)	166	(12,518)
Total operating expenses				<u>(114,255)</u>	<u>(27,081)</u>	<u>(93,532)</u>	<u>3,588</u>	<u>(231,280)</u>
Operating profit/(loss)				9,500	(10,782)	206,880	166	205,764
Other income				5,022	7	209	0	5,238
Interest income				2,659	65	7,588	0	10,312
Exchange difference				(3,367)	(648)	(489)	0	(4,504)
Income/(loss) before income tax expense				13,814	(11,358)	214,188	166	216,810
Income tax expense				(4,114)	0	(31,610)	0	(35,724)
Net income				<u>\$ 9,700</u>	<u>\$(11,358)</u>	<u>\$182,578</u>	<u>\$ 166</u>	<u>\$ 181,086</u>

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

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

As of September 30, 2012

	Brand Advertising, Wireless and Others				Sogou	Changyou	Eliminations	Consolidated
	Brand Advertising	Wireless	Others	Brand Advertising, Wireless and Others				
Cash and cash equivalents	\$ 437,382	\$35,821	\$ 300,266	\$ 0	\$ 773,469			
Accounts receivable, net	70,527	4,151	23,412	0	98,090			
Fixed assets, net	66,344	38,518	65,553	0	170,415			
Total assets (1)	\$1,024,358	\$82,630	\$1,019,772	\$(176,075)	\$1,950,685			

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

	As of December 31, 2011				
	Brand Advertising, Wireless and Others	Sogou	Changyou	Eliminations	Consolidated
Cash and cash equivalents	\$ 357,031	\$45,165	\$ 330,411	\$ 0	\$ 732,607
Accounts receivable, net	73,610	2,263	11,326	(133)	87,066
Fixed assets, net	61,636	22,622	68,394	0	152,652
Total assets (1)	\$ 934,096	\$73,970	\$753,073	\$(127,845)	\$1,633,294

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

### 3. Share-Based Compensation Expense

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

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

On January 4, 2012, Sohu Video, the holding entity of Sohu’s video division, adopted a 2011 Share Incentive Plan (the “Video 2011 Share Incentive Plan”), which provides for the issuance of up to 25,000,000 ordinary shares of Sohu Video (amounting to 10% of the outstanding Sohu Video shares on a fully-diluted basis) to management and key employees of the video division and to Sohu management. As of September 30, 2012, grants of options for the purchase of 15,352,200 of ordinary shares of Sohu Video had been made and were effective under the plan. However, as of September 30, 2012, the restructuring of Sohu’s video division was still in process and certain significant factors remained uncertain. For purposes of ASC 718, no grant date is established until mutual understanding of the option awards’ key terms and conditions between Sohu Video and the recipients can be reached, and such mutual understanding cannot be reached until the video division’s restructuring plan has been substantially fixed, so that the enterprise value of Sohu Video and hence the fair value of the options is determinable and can be accounted for. As of September 30, 2012, on the basis that the broader terms and conditions of the option awards had neither been finalized nor mutually agreed with the recipients, no grant of options had occurred for purposes of ASC 718 and hence no share based compensation expense was recognized.

On July 10, 2012, 7Road adopted a 2012 Share Incentive Plan (the “7Road 2012 Share Incentive Plan”), which initially provided for the issuance of up to 5,100,000 ordinary shares of 7Road (amounting to 5.1% of the outstanding 7Road shares on a fully-diluted basis) to selected directors, officers, employees, consultants and advisors of 7Road. On November 2, 2012, the number of ordinary shares available for issuance under the 7Road 2012 Share Incentive Plan was increased to 15,100,000 shares. See Note 16 - Subsequent Events. As of September 30, 2012, 2,546,250 restricted share units had been granted under the plan. Such restricted share units will not be vested until 7Road’s completion of a firm commitment underwritten initial public offering (the “IPO”) of its shares resulting in a listing on an internationally recognized exchange and the expiration of all underwriters’ lockup periods applicable to the IPO. The completion of an IPO is considered to be a performance condition of the awards. An IPO event is not considered to be probable until it is completed. Under ASC 718, compensation cost should be accrued if it is probable that the performance condition will be achieved and should not be accrued if it is not probable that the performance condition will be achieved. As a result, no compensation expense will be recognized relating to these restricted share units until the completion of the IPO, and hence no share based compensation expense was recognized for the quarter ended September 30, 2012.

Share-based compensation expense was recognized in costs and/or expenses for the three and nine months ended September 30, 2012 and September 30, 2011, respectively, as follows (in thousands):

Share-based compensation expense	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of revenues	\$ 232	\$ 253	\$ 426	\$ 1,543
Product development expenses	1,316	1,633	4,019	4,826
Sales and marketing expenses	582	874	1,613	2,835
General and administrative expenses	1,713	1,617	4,144	4,857
	<u>\$3,843</u>	<u>\$4,377</u>	<u>\$10,202</u>	<u>\$14,061</u>

There was no capitalized share-based compensation expense for the three and nine months ended September 30, 2012 and 2011.

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Share-based compensation expense recognized for share awards of Sohu, Changyou, Sogou, Sohu Video and 7Road, respectively, was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Share-based compensation expense				
For Sohu share-based awards	\$ 1,440	\$ 2,607	\$ 4,621	\$ 8,735
For Changyou share-based awards	750	1,172	2,769	4,210
For Sogou share-based awards	1,653	598	2,812	1,116
For Sohu Video share-based awards	0	—	0	—
For 7Road share-based awards	0	—	0	—
	<u>\$ 3,843</u>	<u>\$ 4,377</u>	<u>\$ 10,202</u>	<u>\$ 14,061</u>

#### 4. Changyou Distribution of Cash Dividend

On August 6, 2012, Changyou declared a special one-time cash dividend of \$1.90 per Class A or Class B ordinary share, or \$3.80 per ADS. On September 21, 2012, Changyou paid out this special cash dividend of \$201 million, with \$136 million paid to and received by Sohu.

#### 5. Fair Value Measurements

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

The Company's financial instruments include cash equivalents, restricted time deposits, short-term investments, accounts receivable, investments in debt securities, prepaid and other current assets, accounts payable, short-term bank loans, accrued liabilities, receipts in advance and deferred revenue, other short-term liabilities and long-term bank loans. The carrying amount of accounts receivable, prepaid and other current assets, accounts payable, receipts in advance and deferred revenue, accrued liabilities and other short-term liabilities approximates their fair value. Other financial instruments are measured at their respective fair values. For fair value measurements, U.S. GAAP establishes a three-tier hierarchy which prioritizes the inputs used in the valuation methodologies in measuring fair value:

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

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

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

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of September 30, 2012 (in thousands):

Items	As of September 30, 2012	Fair value measurements at reporting date using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 285,404	\$ 0	\$ 285,404	\$ 0
Restricted time deposits	225,757	0	225,757	0
Short-term investments	41,930	0	41,930	0
Investments in debt securities	78,852	0	0	78,852
Total Assets	<u>\$ 631,943</u>	<u>\$ 0</u>	<u>\$ 553,091</u>	<u>\$ 78,852</u>
Short-term bank loans	113,000	0	113,000	0
Long-term bank loans	109,353	0	109,353	0
Total Liabilities	<u>\$ 222,353</u>	<u>\$ 0</u>	<u>\$ 222,353</u>	<u>\$ 0</u>

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The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of December 31, 2011 (in thousands):

Items	As of December 31, 2011	Fair value measurements at reporting date using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 166,675	\$ 0	\$ 166,675	\$ 0
Short-term investments	17,560	0	17,560	0
Investments in debt securities	79,354	0	0	79,354
Total	<u>\$ 263,589</u>	<u>\$ 0</u>	<u>\$ 184,235</u>	<u>\$ 79,354</u>

The following table sets forth the reconciliation of the fair value measurements using significant unobservable inputs (level 3) from December 31, 2011 to September 30, 2012 (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Debt Securities
Beginning balance at December 31, 2011	\$ 79,354
Currency translation adjustment	(502)
Ending balance at September 30, 2012	<u>\$ 78,852</u>

### **Cash equivalents**

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

### **Short-term investments**

In accordance with ASC 825, for investments in financial instruments with a variable interest rate indexed to performance of underlying assets, the Company elected the fair value method at the date of initial recognition and carried these investments at fair value. Changes in the fair value are reflected in the consolidated statements of comprehensive income as other income/(expense). Fair value is estimated based on quoted prices of similar products provided by banks at the end of each period. The Company classifies the valuation techniques that use these inputs as Level 2 of fair value measurements.

As of September 30, 2012, the Company's investments in financial instruments were mainly held by 7Road's VIE Shenzhen 7Road Technology Co., Ltd ("Shenzhen 7Road"), and totaled approximately \$40.4 million. The investments are issued by commercial banks in China with a variable interest rate indexed to performance of underlying assets. Since these investments' maturity dates are within one year, they are classified as short-term investments. For the three and nine months ended September 30, 2012, the Company recorded in the consolidated statements of comprehensive income change in the fair value of short-term investments in the amount of \$0.4 million and \$1.0 million, respectively.

### **Investments in debt securities**

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

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For the three and nine months ended September 30, 2012, interest income generated from this debt security amounted to \$1.37 million and \$4.10 million, respectively. For the three and nine months ended September 30, 2011, interest income generated from this debt security amounted to \$0.76 million and \$2.21 million respectively.

The Company elected the fair value option to account for its investments in debt securities at their initial recognition. Changes in fair value were recognized in other income/(expense). For the three and nine months ended September 30, 2012, there was no change in fair value. For the three and nine months ended September 30, 2011, changes in fair value generated from exchange gain or loss were \$1.40 million and \$3.15 million respectively. To estimate fair value, the Company used the income approach, which considers the estimated future return from the investment and the probabilities of getting these returns. The Company classifies the valuation techniques that use these inputs as Level 3 of fair value measurements.

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

In the third quarter of 2012, Changyou drew down offshore bridge loans from branches of certain banks for the purposes of expediting the payment of the special one-time cash dividend to its shareholders and providing working capital to support its overseas operations. All of these bridge loans were secured by an equivalent or greater amount of RMB deposits by Changyou in the onshore branches of such banks. As of September 30, 2012, the total amount of loan was \$222 million, of which \$123 million carried a floating rate of interest based on the London Inter-Bank Offered Rate ("LIBOR") and \$99 million carried a fixed rate of interest.

The offshore bridge loans from the branches of the lending banks are classified as short-term bank loans or long-term bank loans based on their payment terms. The RMB onshore deposits securing the offshore loans are treated as restricted time deposits on the Company's consolidated balance sheets. Restricted time deposits are valued based on the prevailing interest rates in the market. The rates of interest under the loan agreements with the lending banks to determine were also determined based on the prevailing interest rates in the market. The Company classifies the valuation techniques that use these inputs as Level 2 of fair value measurements of offshore bridge bank loans.

For the three months ended September 30, 2012, interest income from the restricted time deposits securing the loans was \$1.5 million, and interest expense on the bank loans was \$0.3 million.

## **6. Impairment of purchased video content**

The Company recorded payments for video content as prepaid assets when payment occurred, then capitalized the purchased video content as intangible assets when recognition criteria were met.

In the second quarter of 2012, the Company noted that the prices for purchased video content have decreased significantly. Under *ASC 360-10-35-Impairment or Disposal of Long-Lived Assets*, when events or changes in circumstances indicate that the carrying amount of long-lived assets may not be recoverable, an impairment test should be performed at the asset group level. The Company divided purchased video content into seven asset groups, consisting of TV series, Pay Channel, Overseas Content, Movies, Animations, Variety shows, and Documentary films. The Company tested the recoverability of the carrying values of these asset groups by comparing their carrying amounts to the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset groups. If the carrying amount of an asset group was determined to not be recoverable, an impairment loss was recognized, measured by comparing the carrying value of the asset group to the asset group's fair value. The fair values of the purchased video content were estimated using the discounted cash flow method. The impairment losses were allocated only to the purchased video content within the asset group, since the carrying amount of other long-lived assets within the asset group was considered to be already below their fair value.

As a result of these impairment tests, the Company recognized total impairment losses of \$15.1 million in the consolidated statements of comprehensive income as cost of revenues. Also, the Company wrote down prepaid assets and intangible assets totaling \$15.1 million.

For the three and nine months ended September 30, 2011, no impairment losses were recognized for purchased video content.



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### 7. Goodwill

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

	<u>Brand Advertising</u>	<u>Wireless</u>	<u>Sogou</u>	<u>Changyou</u>	<u>Total</u>
Balance as of December 31, 2011					
Goodwill	\$ 59,978	\$ 15,942	\$ 2,042	\$ 121,932	\$ 199,894
Accumulated impairment losses	(19,846)	(15,942)	0	(5,201)	(40,989)
	<u>\$ 40,132</u>	<u>\$ 0</u>	<u>\$ 2,042</u>	<u>\$ 116,731</u>	<u>\$ 158,905</u>
Transactions in 2012					
Inter-segment transfers	(17,885)	0	0	17,885	0
Foreign currency translation adjustment	(1)	0	(13)	(787)	(801)
Balance as of September 30, 2012	<u>\$ 22,246</u>	<u>0</u>	<u>2,029</u>	<u>133,829</u>	<u>158,104</u>
Balance as of September 30, 2012					
Goodwill	\$ 42,092	\$ 15,942	\$ 2,029	\$ 139,030	\$ 199,093
Accumulated impairment losses	(19,846)	(15,942)	0	(5,201)	(40,989)

The inter-segment transfers are related to the sale of the 17173 Business by Sohu to Changyou. As aforementioned in Note 2 - Segment Information, beginning January 1, 2012, the Company began to review the 17173 Business as part of the Changyou segment and changed the Company's segment operating performance measurements by transferring the 17173 Business from the brand advertising segment to the Changyou segment, therefore, the related goodwill was transferred accordingly.

### 8. Taxation

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

The Company did not have any penalties or significant interest associated with tax positions for the three and nine months ended September 30, 2012, nor did the Company have any significant unrecognized uncertain tax positions for the three and nine months ended September 30, 2012.

#### **PRC Corporate Income Tax**

##### *Related to High and New Technology Enterprises*

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

Within the Sohu Group, there were five enterprises that qualified as NHTEs in 2008 and were qualified upon re-application in 2011. These enterprises are Beijing Sohu New Era Information Technology Co., Ltd. ("Sohu Era"), Beijing Sohu New Media Information Technology Co., Ltd. ("Sohu Media"), Beijing Sogou Technology Development Co., Ltd. ("Sogou Technology"), Changyou's China-based subsidiary Beijing AmazGame Age Internet Technology Co., Ltd. ("AmazGame") and Changyou's China-based VIE Beijing Gamease Age Digital Technology Co., Ltd. ("Gamease"). Hence, for these enterprises the income tax rate is 15% for 2012 and 2013.

In addition to the above five enterprises, there are other two enterprises, Beijing Sohu Internet Information Service Co., Ltd. ("Sohu Internet") and Beijing Sogou Information Service Co., Ltd. ("Sogou Information") that qualified as NHTEs in 2009 and reapplied for qualification in May 2012. Before the reapplications are approved, the two companies will be entitled to continue to enjoy their beneficial tax rates as if they had already qualified as NHTEs for 2012. Therefore, for the year 2012, the income tax rate for these enterprises will be 15%.

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### *Related to Software Enterprises*

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

As of September 30, 2012, Shenzhen 7Road, Beijing Changyou Gamespace Software Technology Co., Ltd. (“Gamespace”), Beijing Guanyou Gamespace Digital Technology Co., Ltd. (“Guanyou Gamespace”), ICE Information Technology (Shanghai) Co., Ltd. (“ICE Information”) and Shanghai ICE Information Technology Co., Ltd. (“Shanghai ICE”) were “Software Enterprises” entitled to the beneficial tax treatment described above.

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

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

In 2012, Changyou’s Board of Directors determined to cause one of Changyou’s PRC subsidiaries to distribute all of its 2012 earnings to its overseas parent company, Changyou.com HK Limited (“Changyou HK”). Based on an assessment performed pursuant to requirements specified by PRC tax authorities, Changyou concluded that it was more likely than not that such distribution would be subject to 5% withholding tax. For the nine months ended September 30, 2012, Changyou accrued deferred tax liabilities in the amount of \$8.7 million for withholding taxes associated with this distribution plan.

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

Effective September 1, 2012, a pilot program for transition from the imposition of PRC business tax (“Business Tax”) to the imposition of value added tax (“VAT”) for revenues from certain industries was expanded from Shanghai to eight other cities and provinces in China, including Beijing and Tianjin. The Company’s brand advertising and search revenues are subject to this program.

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

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

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

## 9. Commitments and Contingencies

### *Contractual Obligation*

In November 2009, the Company entered into an agreement to purchase a Beijing office building to serve as the Company's headquarters. The purchase price is approximately \$127 million, of which \$107 million had been paid as of September 30, 2012. In December 2011, the Company also entered into an agreement for technological infrastructure and fitting-out work for this office building. The contractual amount is approximately \$28 million, of which \$16 million had been paid as of September 30, 2012. These \$107 million and \$16 million payments have been recognized as prepaid non-current assets in the Company's consolidated balance sheets. The remaining \$20 million for the office building and \$12 million for the technological infrastructure and fitting-out work will be settled in installments as various stages of the development plan are completed. This office building and related technological infrastructure and fitting-out work are in progress and are expected to be completed in 2013.

In August 2010, Changyou entered into an agreement to purchase a Beijing office building to serve as its headquarters. The purchase price is approximately \$157 million, of which \$125 million had been paid as of September 30, 2012 and was recognized as prepaid non-current assets in the Company's consolidated balance sheets. The remaining \$32 million will be settled by early of 2013, when the office building development is expected to be completed.

In the third quarter of 2012, Changyou drew down offshore bridge bank loans of \$222 million, which were secured by the equivalent or greater amount of RMB deposits in onshore branches of those banks, totaling RMB1.43 billion (\$226 million).

As of September 30, 2012, the Sohu Group had commitments for bandwidth purchases in the amount of \$25 million, commitments for video content purchases in the amount of \$19 million, commitments for operating leases in the amount of \$12 million and commitments for other content and service purchases in the amount of \$12 million.

### *Litigation*

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

In March 2008, the Sohu Group was sued by four major record companies, Sony BMG, Warner, Universal and Gold Label, which alleged that the Sohu Group provided music search links and download services that violated copyrights they owned. As of September 30, 2012, the lawsuits with these four record companies were still in process. At this stage, an estimation of the loss cannot be made.

### *PRC Law*

The Chinese market in which the Sohu Group operates poses certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability to operate an Internet business and to conduct brand advertising, search and others, online game, wireless and others services in the PRC. Though the PRC has, since 1978, implemented a wide range of market-oriented economic reforms, continued reforms and progress towards a full market-oriented economy are uncertain. In addition, the telecommunication, information, and media industries remain highly regulated. Restrictions are currently in place and are unclear with respect to which segments of these industries foreign-owned entities, like the Sohu Group, may operate. The Chinese government may issue from time to time new laws or new interpretations of existing laws to regulate areas such as telecommunication, information and media. Certain risks related to PRC law that could affect Sohu Group's VIE structure are discussed in Note 10 - VIEs.

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

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

## 10. VIEs

### **Background**

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

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

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

Under contractual agreements with the Sohu Group, Dr. Charles Zhang and those other executive officers and employees of the Sohu Group who are shareholders of the VIEs are required to transfer their ownership in these entities to the Sohu Group, if permitted by PRC laws and regulations, or, if not so permitted, to designees of the Sohu Group at any time as requested by Sohu Group to repay the loans outstanding. All voting rights of the VIEs are assigned to the Sohu Group, and the Sohu Group has the right to designate all directors and senior management personnel of the VIEs, and also has the obligation to absorb losses of the VIEs. Dr. Charles Zhang and those other executive officers and employees of the Sohu Group who are shareholders of the VIEs have pledged their shares in the VIEs as collateral for the loans. As of September 30, 2012, the aggregate amount of these loans was \$16.6 million.

Under its contractual arrangements with the VIEs, the Company has the power to direct activities of the VIEs, and can have assets transferred freely out of the VIEs without any restrictions. Therefore, the Company considers that there is no asset of a consolidated VIE that can be used only to settle obligations of the VIEs, except for registered capital and PRC statutory reserves of the VIEs. As of September 30, 2012, the registered capital and PRC statutory reserves of the VIEs totaled \$30.4 million. As all the consolidated VIEs are incorporated as limited liability companies under the PRC Company Law, creditors of the VIEs do not have recourse to the general credit of the Company for any of the liabilities of the consolidated VIEs. Currently there is no contractual arrangement that could require the Company to provide additional financial support to the consolidated VIEs. As the Company is conducting certain business in the PRC mainly through the VIEs, the Company may provide such support on a discretionary basis in the future, which could expose the Company to a loss.

### **Summary of VIEs**

#### *Basic Information*

##### Corporate

a) High Century

Beijing Century High Tech Investment Co., Ltd. ("High Century") is a holding company which was incorporated in 2001. As of September 30, 2012, the registered capital of High Century was \$4.6 million. Dr. Charles Zhang, the Company's Chairman of the Board and Chief Executive Officer, and Wei Li, held 80% and 20% interests, respectively, in this entity.

b) Sohu Entertainment

Beijing Sohu Entertainment Culture Media Co., Ltd. ("Sohu Entertainment") was incorporated in 2002. As of September 30, 2012, the registered capital of Sohu Entertainment was \$1.2 million. Xin Wang (Belinda Wang), the Company's Co-President and Chief Operating Officer, and Ye Deng, a Vice President of the Company, held 80% and 20% interests, respectively, in this entity.

c) Sohu Internet

Sohu Internet was incorporated in 2003. As of September 30, 2012, the registered capital of Sohu Internet was \$1.6 million. High Century and Sohu Entertainment held 75% and 25% interests, respectively, in this entity.

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### For the Online Advertising Business

#### Brand Advertising Business

- d) Donglin  
Beijing Sohu Donglin Advertising Co., Ltd. (“Donglin”) was incorporated in 2010 and is engaged in advertising services. As of September 30, 2012, the registered capital of Donglin was \$1.5 million. High Century and Sohu Internet each held a 50% interest in this entity.
- e) Pilot New Era  
Beijing Pilot New Era Advertising Co., Ltd. (“Pilot New Era”) was incorporated in 2010 and is engaged in advertising services. As of September 30, 2012, the registered capital of Pilot New Era was \$0.7 million. High Century and Sohu Internet each held a 50% interest in this entity.
- f) Focus Yiju  
Beijing Focus Yiju Network Information Technology Co., Ltd. (“Focus Yiju”) was acquired in 2011 and is engaged in advertising services. As of September 30, 2012, the registered capital of Focus Yiju was \$1.6 million. High Century held a 100% interest in this entity.
- g) 17173 Network  
Beijing 17173 Network Technology Co., Ltd. (“17173 Network”) was incorporated in 2011 and is engaged in technology development and advertising services. As of September 30, 2012, the registered capital of 17173 Network was \$1.6 million. Jing Zhou and a third party entity each held a 50% interest in this entity.
- h) Tianjin Jinhu  
Tianjin Jinhu Culture Development Co., Ltd. (“Tianjin Jinhu”) was incorporated in 2011 and is engaged in advertising services. As of September 30, 2012, the registered capital of Tianjin Jinhu was \$0.5 million. Ye Deng and Chun Liu each held a 50% interest in this entity.
- i) Tu Xing Tian Xia  
Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (“Tu Xing Tian Xia”) was acquired in 2005 and is engaged in mapping services. As of September 30, 2012, the registered capital of Tu Xing Tian Xia was \$0.2 million. Beijing Century High-Tech Investment Co., Ltd. (“High Century”) and Sohu Internet held 56.1% and 43.9% interests, respectively, in this entity. This entity is currently in the process of liquidation.

#### Search and Others Business

- j) Sogou Information  
Sogou Information was incorporated in 2005. As of September 30, 2012, the registered capital of Sogou Information was \$2.5 million. Xiaochuan Wang, the Company’s Chief Technology Officer, and Xianxian Hao each held a 50% interest in this entity.

### For the Online Game Business

- k) Gamease  
Gamease was incorporated in 2007. As of September 30, 2012, the registered capital of Gamease was \$1.3 million. Tao Wang, Chief Executive Officer of Changyou, and Dewen Chen, President and Chief Operating Officer of Changyou held 60% and 40% interests, respectively, in this entity.
- l) Shanghai ICE  
Shanghai ICE was acquired by Changyou in 2010. As of September 30, 2012, the registered capital of Shanghai ICE was \$1.2 million. Runa Pi and Rong Qi each held a 50% interest in this entity.
- m) Guanyou Gamespace  
Guanyou Gamespace was incorporated in 2010. As of September 30, 2012, the registered capital of Guanyou Gamespace was \$1.5 million. Tao Wang and Dewen Chen held 60% and 40% interests, respectively, in this entity.

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### n) Shenzhen 7Road

68.258% of Shenzhen 7Road was acquired by Gamease in 2011. In the second quarter of 2012, in connection with a reorganization of Shenzhen 7Road to create a Cayman Islands holding company structure, Shenzhen 7Road became a VIE of 7Road, which is a Cayman Islands company of which approximately 71.926% is owned by Changyou. Shenzhen 7Road is controlled by Changyou, and Changyou is a primary beneficiary of Shenzhen 7Road, as a result of contractual arrangements among Shenzhen 7Road, Shenzhen 7Road Network Technologies Co., Ltd. ("7Road Technology"), which is a PRC-based indirect wholly-owned subsidiary of 7Road, and the shareholders of Shenzhen 7Road. As of September 30, 2012, Gamease held shares representing 68.258% of Shenzhen 7Road and four executive officers of 7Road.com Limited collectively held shares representing 31.742% of Shenzhen 7Road.

### For the Wireless Business

#### o) GoodFeel

Beijing GoodFeel Information Technology Co., Ltd. ("GoodFeel") was acquired in 2004 and is engaged in value added telecommunication services. As of September 30, 2012, the registered capital of GoodFeel was \$1.2 million. James Deng and Jing Zhou, held 58.1% and 41.9% interests, respectively, in this entity.

#### p) 21 East Beijing

Beijing 21 East Culture Development Co., Ltd. ("21 East Beijing") was acquired in 2006. As of September 30, 2012, the registered capital of 21 East Beijing was \$0.1 million and High Century held a 100% interest in this entity.

#### q) Yi He Jia Xun

Beijing Yi He Jia Xun Information Technology Co., Ltd. ("Yi He Jia Xun") was acquired in September 2011. As of September 30, 2012, the registered capital of Yi He Jia Xun was \$2.1 million and Gang Fang and Yanfeng Lv each held a 50% interest in this entity.

### Financial Information

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

	As of				
	September 30, 2012		December 31, 2011		
Total assets	\$	509,892	\$	405,854	
Total liabilities	\$	191,873	\$	184,711	
	Three months ended September 30,		Nine months ended September 30,		
	2012	2011	2012	2011	
Net revenue	\$	233,802	\$	639,947	
Net income	\$	38,439	\$	92,100	
		\$	6,521	\$	34,938

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

### Cash flows of Sohu's VIEs

	Nine months ended September 30,	
	2012	2011
Net cash (used in) /provided by operating activities	\$	(16,930)
Net cash provided by /(used in) investing activities		143
Net cash used in financing activities	\$	(474)

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### Cash flows of Changyou's VIEs

	Nine months ended September 30,	
	2012	2011
Net cash provided by operating activities	\$ 41,843	\$ 89,996
Net cash used in investing activities	(31,558)	(94,977)
Net cash used in financing activities	\$ (13,105)	\$ 0

### *Summary of significant agreements currently in effect*

#### Agreements between VIEs and Nominee Shareholders

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### Business Arrangements Between Subsidiaries and VIEs

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

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

*Technology support and utilization agreements* between AmazGame and Gamease and between Gamespace and Guanyou Gamespace. Pursuant to these agreements, AmazGame and Gamespace, respectively, have the exclusive right to provide certain product development and application services and technology support to Gamease and Guanyou Gamespace, respectively, for a fee equal to a predetermined percentage, subject to adjustment by AmazGame or Gamespace at any time, of Gamease's and Guanyou Gamespace's respective revenues. These agreements will be terminated only when AmazGame and Gamespace are dissolved.

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



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

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

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

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

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

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

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

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

## **11. Sohu.com Inc. Shareholders' Equity**

### ***Takeover Defense***

Sohu's stockholder rights plan, which had been in effect since 2001, expired in July of 2011. Sohu intends to adopt appropriate defensive measures in the future on a case by case basis as and to the extent that the Company's Board of Directors determines that such measures are necessary or advisable to protect Sohu stockholder value in the face of any coercive takeover threats or to prevent an acquirer from gaining control of the Company without offering fair and adequate price and terms.

### ***Treasury Stock***

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

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

### **Stock Incentive Plans**

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

#### *1) Sohu.com Inc. Share-based Awards*

##### Sohu's 2000 Stock Incentive Plan

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

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for awards under the Sohu 2000 Stock Incentive Plan was \$1.2 million and \$3.9 million, respectively. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for awards under the Sohu 2000 Stock Incentive Plan was \$2.3 million and \$7.8 million, respectively.

#### *i) Summary of share option activity*

A summary of share option activity under the Sohu 2000 Stock Incentive Plan as of and for the nine months ended September 30, 2012 is presented below:

<b>Options</b>	<b>Number Of Shares (in thousands)</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Aggregate Intrinsic Value (1) (in thousands)</b>
Outstanding at January 1, 2012	329	\$ 16.73	2.52	\$ 10,934
Exercised	(30)	8.05		
Forfeited or expired	(1)	13.97		
Outstanding at September 30, 2012	298	17.60	1.89	7,307
Vested at September 30, 2012	298	17.60	1.89	7,307
Exercisable at September 30, 2012	298	17.60	1.89	7,307

Note (1): The aggregate intrinsic value in the preceding table represents the difference between Sohu's closing stock price of \$42.09 on September 30, 2012 and the exercise price of share options. The total intrinsic value of share options exercised for the nine months ended September 30, 2012 was \$1.3 million.

No options have been granted under Sohu's 2000 Stock Incentive Plan since 2006. For the three and nine months ended September 30, 2012 and 2011, no compensation expense was recognized for share options because the requisite service periods for share options had ended by the end of 2009.

For the three and nine months ended September 30, 2012, total cash received from the exercise of share options amounted to \$101,000 and \$240,000, respectively. For the three and nine months ended September 30, 2011, total cash received from the exercise of share options amounted to \$0.1 million and \$1.5 million, respectively.

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### ii) Summary of restricted share unit activity

A summary of restricted share units activity under the Sohu 2000 Stock Incentive Plan as of and for the nine months ended September 30, 2012 is presented below:

<u>Restricted Share Units</u>	<u>Number of Units (in thousands)</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Unvested at January 1, 2012	445	\$ 61.66
Granted	0	
Vested	(153)	62.41
Forfeited	(30)	61.27
Unvested at September 30, 2012	<u>262</u>	<u>61.27</u>
Expected to vest thereafter	<u>195</u>	<u>61.27</u>

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for restricted share units was \$1.2 million and \$3.9 million, respectively. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for restricted share units was \$2.3 million and \$7.8 million, respectively.

As of September 30, 2012, there was \$3.5 million of unrecognized compensation expense related to unvested restricted share units. The expense is expected to be recognized over a weighted average period of 0.67 years. The total fair value on their respective vesting dates of restricted share units vested during the three and nine months ended September 30, 2012 was nil and \$8.9 million, respectively. The total fair value on their respective vesting dates of restricted share units vested during the three and nine months ended September 30, 2011 was \$0.5 million and \$14.9 million, respectively.

### Sohu's 2010 Stock Incentive Plan

On July 2, 2010, the Company's shareholders approved Sohu's 2010 Stock Incentive Plan (the "Sohu 2010 Stock Incentive Plan"), which provides for the issuance of up to 1,500,000 shares of common stock, including those issued pursuant to the vesting and settlement of restricted share units and pursuant to the exercise of share options. The maximum term of any issued stock right under the Sohu 2010 Stock Incentive Plan is ten years from the grant date. The Sohu 2010 Stock Incentive Plan will expire on July 1, 2020. As of September 30, 2012, 1,466,461 shares were available for grant under the Sohu 2010 Stock Incentive Plan.

A summary of restricted share units activity under the Sohu 2010 Stock Incentive Plan as of and for the nine months ended September 30, 2012 is presented below:

<u>Restricted Share Units</u>	<u>Number of Units (in thousands)</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Unvested at January 1, 2012	14	\$ 70.88
Granted	12	52.19
Vested	(6)	52.19
Forfeited	(5)	70.88
Unvested at September 30, 2012	<u>15</u>	<u>63.53</u>
Expected to vest thereafter	<u>12</u>	<u>62.10</u>

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for restricted share units was \$0.2 million and \$0.6 million, respectively.

As of September 30, 2012, there was \$0.5 million of unrecognized compensation expense related to unvested restricted share units. The expense is expected to be recognized over a weighted average period of 0.72 years. The total fair value on their respective vesting dates of restricted share units vested during both the three months and the nine months ended September 30, 2012 was \$0.25 million. The total fair value on their respective vesting dates of restricted share units vested during both the three months and during the nine months ended September 30, 2011 was \$0.27 million.

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

Changyou's ordinary shares are divided into Class A ordinary shares and Class B ordinary shares. Holders of Class A ordinary shares and holders of Class B ordinary shares have the same rights in Changyou, with the exception of voting and conversion rights. Each Class A ordinary share is entitled to one vote on all matters subject to a shareholder vote, and each Class B ordinary share is entitled to ten votes on all matters subject to a shareholder vote. Each Class B ordinary share is convertible into one Class A ordinary share at any time at the election of the holder. Class A ordinary shares are not convertible into Class B ordinary shares under any circumstances.

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On December 31, 2008, Changyou reserved 2,000,000 of its ordinary shares, which included 1,774,000 Class B ordinary shares and 226,000 Class A ordinary shares, for issuance to certain of its executive officers and employees as incentive compensation under Changyou's 2008 Share Incentive Plan (the "Changyou 2008 Share Incentive Plan"). In March 2009, the 2,000,000 reserved ordinary shares were subject to a ten-for-one share split effected by Changyou and became 20,000,000 ordinary shares.

As of September 30, 2012, Changyou has granted under the Changyou 2008 Share Incentive Plan 15,000,000 Class B ordinary shares to Tao Wang through Prominence Investments Ltd. ("Prominence") and 4,745,200 Class A and Class B restricted share units (settleable by Changyou's issuance of Class A ordinary shares and Class B ordinary shares, respectively) to certain of its executive officers other than Tao Wang and to certain of its employees and certain Sohu employees. Prominence is an entity that may be deemed under applicable rules of the Securities and Exchange Commission (the "SEC") to be beneficially owned by Tao Wang.

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for awards under the Changyou 2008 Share Incentive Plan was \$0.8 million and \$2.8 million, respectively. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for awards under the Changyou 2008 Share Incentive Plan was \$1.2 million and \$4.2 million, respectively.

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

#### i) Share-based Award to Tao Wang, Chief Executive Officer of Changyou

In January 2008, Sohu communicated to and agreed with Tao Wang to grant him 700,000 ordinary shares and 800,000 restricted ordinary shares, in lieu of his contingent right in one of the Sohu Group's subsidiaries, which was devoted to the development of TLBB. The 800,000 restricted ordinary shares were subject to a four-year vesting period commencing February 1, 2008. In addition, Tao Wang would not be entitled to participate in any distributions on Changyou shares, whether or not vested, until the earlier of Changyou's completion of an initial public offering or February 2012, and in any event entitlement to distributions would be subject to vesting of the shares. The difference between the fair value ("Incremental Fair Value") of these 700,000 ordinary shares and 800,000 restricted ordinary shares and Tao Wang's contingent right in Beijing Fire Fox was accounted for as share-based compensation expense.

In January 2009, Changyou issued 700,000 of its Class B ordinary shares and 800,000 of its Class B restricted ordinary shares under its 2008 Share Incentive Plan to Tao Wang through Prominence.

In February 2009, 200,000 Class B restricted ordinary shares held by Prominence became vested. Upon this vesting, the number of Class B ordinary shares held beneficially by Tao Wang increased to 900,000 shares and the number of Class B restricted ordinary shares held beneficially by Tao Wang decreased to 600,000 shares.

On March 16, 2009, in preparation for its initial public offering, Changyou effected a ten-for-one share split that resulted in the aforementioned 900,000 Class B ordinary shares and 600,000 Class B restricted ordinary shares becoming 9,000,000 Class B ordinary shares and 6,000,000 Class B restricted ordinary shares, respectively.

For the 700,000 ordinary shares, because the terms of the issuance of these ordinary shares had been approved and were communicated to and agreed with Tao Wang as of January 2, 2008, this was considered the grant date. Accordingly, the Incremental Fair Value was determined as of that date. The portion of the Incremental Fair Value related to these ordinary shares, equal to \$1.8 million, was recognized as share-based compensation expense in product development expenses for the three months ended March 31, 2008.

For the 800,000 restricted ordinary shares, as a result of the modification of their vesting terms in April 2008, the portion of the Incremental Fair Value related to these shares, equal to \$7.0 million, was determined in April 2008, and was accounted for as share-based compensation expense over the vesting period starting from the date of the modification, following the accelerated basis of attribution. A summary of activity for these restricted ordinary shares as of and for the nine months ended September 30, 2012 is presented below:

<u>Class B Restricted Ordinary Shares</u>	<u>Number of Shares (in thousands)</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Unvested at January 1, 2012	2,000	\$ 1.36
Granted	0	
Vested	(2,000)	1.36
Unvested at September 30, 2012	0	
Expected to vest thereafter	0	

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for the above-mentioned Class B restricted ordinary shares was nil and \$41,000, respectively. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for the above-mentioned Class B restricted ordinary shares was \$0.1 million and \$0.4 million, respectively.

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As of September 30, 2012, there was no unrecognized compensation expense related to Tao Wang's Class B restricted ordinary shares, since they were all vested. The total fair value of Class B restricted ordinary shares vested to Tao Wang on their respective vesting dates during the three and nine months ended September 30, 2012 was nil and \$26.5 million, respectively. The total fair value of Class B restricted ordinary shares vested to Tao Wang on their respective vesting dates during the three and nine months ended September 30, 2011 was nil and \$39.7 million, respectively.

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

### ii) Share-based Awards to Executive Officers (other than Tao Wang) and Certain Key Employees

In April 2008, Changyou approved and communicated to executive officers other than Tao Wang the grant of an aggregate of 180,000 restricted ordinary shares and to certain key employees the grant of an aggregate of 94,000 restricted share units of Changyou (settleable in ordinary shares upon vesting). These restricted ordinary shares and restricted share units were subject to vesting over a four-year period commencing on February 1, 2008, with initial vesting also subject to the listing of Changyou's ordinary shares in an initial public offering by Changyou. The fair value of the awards at grant date was recognized in the consolidated statements of comprehensive income starting from April 2, 2009, when ADSs representing Changyou's Class A ordinary shares were first listed on the NASDAQ Global Select Market.

On January 15, 2009, Changyou issued 180,000 Class B restricted ordinary shares to executive officers other than Tao Wang and granted 94,000 Class B restricted share units to certain key employees, the grant of which had been approved and communicated in April 2008 as described above.

On March 13, 2009, Changyou exchanged the 180,000 Class B restricted ordinary shares for Class B restricted share units (settleable in Class B ordinary shares), that otherwise have the same vesting and other terms as applied to the Class B restricted ordinary shares described above. Following the exchange, Class B restricted share units granted to executive officers other than Tao Wang and certain key employees totaled 274,000.

On March 16, 2009, the above 274,000 Class B restricted share units became 2,740,000 Class B restricted share units as a result of the ten-for-one share split effected on that date.

A summary of activity for the above Class B restricted share units as of and for the nine months ended September 30, 2012 is presented below:

<u>Class B Restricted Share Units</u>	<u>Number of Units (in thousands)</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Unvested at January 1, 2012	635	\$ 1.98
Granted	0	
Vested	(635)	1.98
Forfeited	0	
Unvested at September 30, 2012	0	
Expected to vest thereafter	0	

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for the above 2,740,000 Class B restricted share units was nil and \$31,000, respectively. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for the above 2,740,000 Class B restricted share units was \$0.1 million and \$0.3 million, respectively.

As of September 30, 2012, there was no unrecognized share-based compensation expense since they were all vested. The total fair value of Class B restricted share units vested to Changyou's executive officers (other than Tao Wang) and its employees on their respective vesting dates during the three and nine months ended September 30, 2012 was nil and \$8.4 million, respectively. The total fair value of Class B restricted share units vested to Changyou's executive officers (other than Tao Wang) and its employees on their respective vesting dates during the three and nine months ended September 30, 2011 was nil and \$13.1 million, respectively.

The methods Changyou used to determine the fair value as of the April 2008 grant date of these Class B restricted share units were the same as the methods used for the restricted ordinary shares granted to Tao Wang as described above.

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### iii) Share-based Awards to Other Employees

On February 17, 2009, Changyou granted an aggregate of 45,600 Class A restricted share units (setttable in Class A ordinary shares) to certain of its employees. These restricted share units are subject to vesting over a four-year period commencing upon the completion of the listing of Changyou's Class A ordinary shares in an initial public offering by Changyou. The grant date fair value of the awards was recognized in Sohu's consolidated statements of comprehensive income starting from April 2, 2009, when ADSs representing Changyou's Class A ordinary shares were first listed on the NASDAQ Global Select Market.

On March 16, 2009, the above 45,600 Class A restricted share units became 456,000 Class A restricted share units as a result of a ten-for-one share split effected on that date.

A summary of activity for the Class A restricted share units as of and for the nine months ended September 30, 2012 is presented below:

<u>Class A Restricted Share Units</u>	<u>Number of Units (in thousands)</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Unvested at January 1, 2012	169	\$ 8.00
Granted	0	
Vested	(85)	8.00
Forfeited	(3)	8.00
Unvested at September 30, 2012	81	8.00
Expected to vest thereafter	73	8.00

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for the above 456,000 Class A restricted share units was \$50,000 and \$0.2 million, respectively. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for the above 456,000 Class A restricted share units was \$0.1 million and \$0.4 million, respectively.

As of September 30, 2012, there was \$0.1 million of unrecognized share-based compensation expense related to the unvested Class A restricted share units. The total fair value of Class A restricted share units vested to Changyou's employees on their respective vesting dates during the three and nine months ended September 30, 2012 was nil and \$1.2 million, respectively. The total fair value of Class A restricted share units vested to Changyou's employees on their respective vesting dates during the three and nine months ended September 30, 2011 was nil and \$1.6 million, respectively.

The fair value of these Class A restricted share units as of the February 17, 2009 grant date was determined based on Changyou's offering price for its initial public offering, which was \$8.00 per Class A ordinary share.

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

#### i) Share-based Awards to Executive Officers (other than Tao Wang) and Certain Key Employees

As of September 30, 2012, in addition to the share-based awards granted before Changyou's initial public offering, Changyou had granted an aggregate of 1,489,200 Class A restricted share units (setttable in Class A ordinary shares) to certain of its executive officers other than Tao Wang and to certain of its employees. These Class A restricted share units are subject to vesting over a four-year period commencing on their grant dates. A summary of activity for the Class A restricted share units as of and for the nine months ended September 30, 2012 is presented below:

<u>Class A Restricted Share Units</u>	<u>Number of Units (in thousands)</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Unvested at January 1, 2012	865	\$ 12.99
Granted	10	12.11
Vested	(318)	12.67
Forfeited	(2)	17.19
Unvested at September 30, 2012	555	13.15
Expected to vest thereafter	530	13.11

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for the above 1,489,200 Class A restricted share units was \$0.6 million and \$2.3 million, respectively. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for the above 1,489,200 Class A restricted share units was \$0.7 million and \$2.7 million, respectively.

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As of September 30, 2012, there was \$2.1 million of unrecognized compensation expense related to the unvested Class A restricted share units. The total fair value of Class A restricted share units vested during the three and nine months ended September 30, 2012 was nil and \$3.9 million, respectively. The total fair value of Class A restricted share units vested during the three and nine months ended September 30, 2011 was nil and \$6.0 million, respectively.

The fair value of restricted share units as of their grant date was determined based on the market price of Changyou's ADSs on that date.

### ii) Share-based Awards to Employees of the 17173 Business

Before Changyou's acquisition of the 17173 Business on December 15, 2011, Changyou had granted an aggregate of 60,000 Class A restricted share units (settleable upon vesting in Class A ordinary shares) to certain employees of the 17173 Business, which was then owned and operated by Sohu, for their involvement in the provision of certain online game links and advertising services to Changyou on Sohu's Websites under a Marketing Services Agreement between Changyou and Sohu.

These Class A restricted share units are subject to graded vesting over a four-year period commencing on the grant date. Before Changyou's acquisition of the 17173 Business on December 15, 2011, the Company accounted for the Class A restricted share units granted by Changyou to employees of the 17173 Business as share awards granted by Sohu to its employees. After December 15, 2011, there was no change in this treatment, as the 17173 Business remained within the Sohu Group. Share-based compensation expense for such restricted share units is recognized on an accelerated basis over the requisite service period and the fair value of restricted share units was determined based on the market price of Changyou's ADSs on the grant date.

A summary of restricted share units to employees of the 17173 Business as of and for the nine months ended September 30, 2012 is presented below:

<u>Class A Restricted Share Units</u>	<u>Number of Units (in thousands)</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Unvested at January 1, 2012	50	\$ 17.67
Granted	0	
Vested	(5)	17.19
Forfeited	(10)	17.42
Unvested at September 30, 2012	35	17.82
Expected to vest thereafter	35	17.82

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for the above 60,000 Class A restricted share units was \$72,000 and \$223,000, respectively.

As of September 30, 2012, there was \$0.3 million of unrecognized compensation expense related to the unvested Class A restricted share units. The expense is expected to be recognized over a weighted average period of 0.95 years. The total fair value of Class A restricted share units vested during the three and nine months ended September 30, 2012 was nil and \$64,000, respectively. The total fair value of Class A restricted share units vested both during the three months and during the nine months ended September 30, 2011 was nil.

The fair value of restricted share units as of their grant date was determined based on the market price of Changyou's ADSs on that date.

### 3) Sogou Inc. Share-based Awards

#### Sogou 2010 Share Incentive Plan

On October 20, 2010, Sogou adopted the Sogou 2010 Share Incentive Plan (the "Sogou 2010 Share Incentive Plan"), which provides for the issuance of up to 24,000,000 ordinary shares of Sogou to management and key employees of Sogou and of any present or future parents or subsidiaries or variable interest entities of Sogou. The maximum term of any issued share right under the Sogou 2010 Share Incentive Plan is ten years from the grant date. The Sogou 2010 Share Incentive Plan will expire on October 19, 2020. As of September 30, 2012, Sogou had issued options for the purchase of 23,334,500 ordinary shares.

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These share options will become vested and exercisable in four equal installments, with each installment vesting upon a service period requirement for management and key employees being met and Sogou's achieving of performance targets for the corresponding period. The performance target for each installment will be set at the beginning of each vesting period, therefore each installment is considered to be granted at that date. After any single employee has received options for the purchase of 100,000 ordinary shares of Sogou, any additional options granted to that employee will be subject to vesting over a four-year period commencing upon Sogou's completion of an initial public offering of its ordinary shares.

Performance targets were set for the first and second installments of Sogou share options, and the options for those installments accordingly were considered granted on April 1, 2011 and May 1, 2012, respectively. As of September 30, 2012, 11,300,900 share options had been granted, and the first installment had become vested and exercisable because both the service period and the performance requirements had been met. A portion of the vested shares was exercised during the nine months ended September 30, 2012.

A summary of share option activity under the Sogou 2010 Stock Incentive Plan as of and for the nine months ended September 30, 2012 is presented below:

<u>Options</u>	<u>Number Of Shares (in thousands)</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>
Outstanding at January 1, 2012	4,767	\$ 0.001	
Granted	6,428	0.001	
Exercised	(4,652)	0.001	
Forfeited or expired	(113)	0.001	
Outstanding at September 30, 2012	6,430	0.001	8.79
Vested at September 30, 2012 and expected to vest thereafter	5,333		
Exercisable at September 30, 2012	105		

For the three and nine months ended September 30, 2012, total share-based compensation expense recognized for share options under the Sogou 2010 Share Incentive Plan was \$1.4 million and \$2.4 million. For the three and nine months ended September 30, 2011, total share-based compensation expense recognized for share options under the Sogou 2010 Share Incentive Plan was \$487,000 and \$960,000, respectively.

As of September 30, 2012, there was \$1.5 million of unrecognized compensation expense related to the unvested share options. The expense is expected to be recognized over a weighted average period of 0.27 years.

Determining the fair value of the ordinary shares of Sogou required complex and subjective judgments regarding its projected financial and operating results, its unique business risks, the liquidity of its ordinary shares and its operating history and prospects at the time the grants were made. The Company estimated the fair value of Sogou's common shares with the assistance of a qualified professional appraiser, primarily using the income approach in the form of discounted cash flow analysis, which is based on Sogou's projected cash flow using management's best estimate as of the valuation date. The Company also used the market approach as a check to corroborate the overall value for Sogou from the income approach by comparing the trading multiples of publicly-traded comparable companies to the implied multiples of Sogou based on the income approach.

The Sogou share-based compensation cost is measured at the fair value of the award as calculated under the Binomial option - pricing model (the "BP Model"). A calculation using the BP Model typically incorporates a large number of very short time periods to reflect a realistic range of possible prices that a share could achieve over the option's contractual term, which could result in several hundred total nodes. In addition, various probabilities could be assigned to each node to reflect the impact that a node is expected to have in conjunction with exercise and post-vesting assumptions. Assumptions used in the BP Model for share-based awards to Sogou management and key employees granted in 2012 are presented below:

<u>Granted to Employees</u>	<u>2012</u>
Average risk-free interest rate	2.93%~3.21%
Exercise multiple	2~3
Expected forfeiture rate (Post-vesting)	1.3%~11.9%
Weighted average expected option life	10
Volatility rate	50.00%~53.00%
Dividend yield	0%
Fair value	0.72



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The Company estimated the risk free rate based on the yield to maturity of China Sovereign bonds denominated in United States dollars as of the valuation date. An exercise multiple was estimated as the ratio of fair value of the shares over the exercise price as of the time the option is exercised, based on consideration of research studies regarding exercise patterns based on historical statistical data. In the Company's valuation analysis, a multiple of two was applied for employees and a multiple of three was applied for management. The Company estimated the forfeiture rate to be 1.3% for Sogou management's and 11.9% for Sogou employees' share options granted as of September 30, 2012. The life of the share options is the contract life of the option. Based on the option agreement, the contract life of the option is 10 years. The expected volatility at the valuation date was estimated based on the historical volatility of comparable companies for the period before the grant date with length commensurate with the expected term of the options. Sogou has no history or expectation of paying dividends on its ordinary shares. Accordingly, the dividend yield is estimated to be 0%.

### Share-based Awards to Sohu management

Under an arrangement approved by the Boards of Directors of Sohu and Sogou in March 2011, Sohu has the right to provide to Sohu management and key employees the opportunity to purchase from Sohu up to 12,000,000 ordinary shares of Sogou at a fixed exercise price of \$0.625 per share. Of these 12,000,000 ordinary shares, 8,800,000 are Sogou ordinary shares previously held by Sohu and 3,200,000 are Sogou ordinary shares that were newly-issued on April 14, 2011 by Sogou to Sohu at a price of \$0.625 per share, or a total of \$2 million. As of September 30, 2012, Sohu had issued options for the purchase of 8,773,000 Sogou ordinary share options to Sohu management and key employees under this arrangement.

These share options will become vested and exercisable in four equal installments, with each installment vesting upon the service period requirement for management and key employees being met and Sogou's achievement of the performance target for the corresponding period. The performance target for each installment will be set at the beginning of each period, therefore each installment is considered to be granted at that date. Performance targets were set for the first and second installments of Sogou share options, and the options for those installments accordingly were considered granted, on April 1, 2011 and May 1, 2012, respectively. As of September 30, 2012, 4,354,500 share options had been granted. The first installment had become vested and exercisable because both the service period and the performance requirements had been met. A portion of the vested shares was exercised during the nine months ended September 30, 2012.

A summary of share option activity as of and for the nine months ended September 30, 2012 is presented below:

<u>Options</u>	<u>Number Of Shares (in thousands)</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>
Outstanding at January 1, 2012	2,188	\$ 0.625	
Granted	2,161	0.625	
Exercised	(2,171)	0.625	
Forfeited or expired	(0)		
Outstanding at September 30, 2012	<u>2,178</u>	0.625	8.60
Vested at September 30, 2012 and expected to vest thereafter	<u>2,056</u>		
Exercisable at September 30, 2012	<u>17</u>		

For the three months and the nine months ended September 30, 2012, total share-based compensation expense recognized for share options under the arrangement was \$200,000 and \$382,000 respectively. For the three and the nine months ended September 30, 2011, total share-based compensation expense recognized for share options under the arrangement was \$111,000 and \$156,000, respectively.

As of September 30, 2012, there was \$245,000 of unrecognized compensation expense related to the unvested share options. The expense is expected to be recognized over a weighted average period of 0.25 years.

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

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Assumptions used in the BP Model for share-based awards to Sohu management and key employees granted in 2012 are presented below:

<u>Granted to Employees</u>	<u>2012</u>
Average risk-free interest rate	2.93%~2.98%
Exercise multiple	2~3
Expected forfeiture rate (Post-vesting)	21.4%~27.0%
Weighted average expected option life	10
Volatility rate	50.00%
Dividend yield	0%
Fair value	0.28~0.32

#### 4) Sohu Video Share-based Awards

On January 4, 2012, Sohu Video adopted the Video 2011 Share Incentive Plan, which provides for the issuance of up to 25,000,000 ordinary shares of Sohu Video (amounting to 10% of the outstanding Sohu Video shares on a fully-diluted basis) to management and key employees of the video division and to Sohu management. The maximum term of any issued share right under the Video 2011 Share Incentive Plan is ten years from the grant date. The Video 2011 Share Incentive Plan will expire on January 3, 2022. As of September 30, 2012, grants of options for the purchase of 15,352,200 of ordinary shares of Sohu Video had been made and were effective under the plan. However, as of September 30, 2012, the restructuring of Sohu's video division was still in process and certain significant factors remained uncertain. For purposes of ASC 718, no grant date is established until mutual understanding of the option awards' key terms and conditions between Sohu Video and the recipients can be reached, and such mutual understanding cannot be reached until the video division's restructuring plan has been substantially fixed, so that the enterprise value of Sohu Video and hence the fair value of the options is determinable and can be accounted for. As of September 30, 2012, on the basis that the broader terms and conditions of the option awards had neither been finalized nor mutually agreed with the recipients, no grant of options had occurred for purposes of ASC 718 and hence no share based compensation expense was recognized.

#### 5) 7Road Share-based Awards

On July 10, 2012, 7Road adopted the 7Road 2012 Share Incentive Plan, which initially provided for the issuance of up to 5,100,000 ordinary shares of 7Road (amounting to 5.1% of the outstanding 7Road shares on a fully-diluted basis) to selected directors, officers, employees, consultants and advisors of 7Road. On November 2, 2012, the number of ordinary shares available for issuance under the 7Road 2012 Share Incentive Plan was increased to 15,100,000 shares. See Note 16 - Subsequent Events. As of September 30, 2012, 2,546,250 restricted share units had been granted under the plan. Such restricted share units will not be vested until 7Road's completion of a firm commitment underwritten IPO of its shares resulting in a listing on an internationally recognized exchange and the expiration of all underwriters' lockup periods applicable to the IPO. The completion of an IPO is considered to be a performance condition of the awards. An IPO event is not considered to be probable until it is completed. Under ASC 718, compensation cost should be accrued if it is probable that the performance condition will be achieved and should not be accrued if it is not probable that the performance condition will be achieved. As a result, no compensation expense will be recognized relating to these restricted share units until the completion of an IPO, and hence no share-based compensation expense was recognized for the quarter ended September 30, 2012.

## 12. Business Restructuring

### **Changyou Transactions**

#### *Initial Public Offering of Changyou*

On April 7, 2009, Changyou completed its initial public offering of 7,500,000 Class A ordinary shares on the NASDAQ Global Select Market, and Sohu sold 9,750,000 Class A ordinary shares of Changyou. Changyou ADSs, each of which represents two Class A ordinary shares, trade on the NASDAQ Global Select Market under the symbol "CYOU."

After the completion of Changyou's initial public offering, as Sohu is Changyou's controlling shareholder, Sohu continues to consolidate Changyou in Sohu's consolidated financial statements, but recognizes noncontrolling interest reflecting shares held by shareholders other than Sohu. For the third quarter of 2012, approximately 32% of the economic interest in Changyou was recognized as noncontrolling interest in Sohu's consolidated financial statements.

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### *Sohu's Shareholding in Changyou*

#### Shareholding and Control

As of September 30, 2012, Changyou had outstanding a combined total of 105,724,168 Class A and Class B ordinary shares. Shares held by Sohu consist of:

- (i) 1,500,000 Class A ordinary shares purchased by Sohu through its wholly-owned subsidiary Sohu.com Limited on the open market during the third quarter of 2011; and
- (ii) 70,250,000 Class B ordinary shares held by Sohu through its indirectly wholly-owned subsidiary Sohu Game.

As of September 30, 2012, Sohu held approximately 68% of the combined total of Changyou's outstanding Class A and Class B ordinary shares and controlled approximately 81% of the total voting power in Changyou. As a result, Sohu had the power to elect the entire Board of Directors of Changyou and determine the outcome of all matters submitted to a shareholder vote. As Changyou's controlling shareholder, Sohu continued to consolidate Changyou in Sohu's consolidated financial statements but recognized noncontrolling interest reflecting shares held by shareholders other than Sohu.

#### Economic Interest

For the third quarter of 2012, Sohu was holding approximately 68% of the economic interest in Changyou. Accordingly, shareholders other than Sohu were treated as holding the remaining 32% of the economic interest, which was recognized as noncontrolling interest in Sohu's consolidated financial statements.

Sohu's economic interest in Changyou, as well as the noncontrolling interest recognized for Changyou in Sohu's consolidated financial statements, will continue to change as the restricted share units granted become vested and settled, and as Sohu purchases Changyou ADSs representing Class A ordinary shares.

#### Dilutive Impact

As of September 30, 2012, Changyou had outstanding a combined total of 1,337,754 Class A and Class B restricted ordinary shares and restricted share units.

Because no Class A ordinary shares or Class B ordinary shares will be issued with respect to these restricted share units until the restricted share units are vested and settled, the unvested restricted share units and vested restricted share units that have not yet been settled are not included as outstanding shares of Changyou and have no impact on Sohu's basic net income per share. Unvested restricted share units and vested restricted share units that have not yet been settled do, however, have a dilutive impact on Sohu's diluted net income per share.

In the calculation of Sohu's diluted net income per share, Sohu's economic interest in Changyou is calculated treating all of Changyou's existing unvested restricted shares, unvested restricted share units, and vested restricted share units that have not yet been settled as vested, in the case of restricted shares, and vested and settled, in the case of restricted share units. See Note 15 - Net Income per Share.

### ***Sogou Transactions***

#### *Sogou Restructuring in 2010*

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

#### *Sohu Purchase of Sogou Series A Preferred Shares in 2012*

On June 29, 2012, Sohu purchased the 24 million Sogou Series A Preferred Shares from Alibaba for fixed cash consideration of \$25.8 million. Under ASC *subtopic 480-10*, changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. The \$14.2 million excess of the purchase price over Alibaba's net investment balance reduced additional paid-in capital in Sohu's consolidated balance sheets.

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### *Sohu's Shareholding in Sogou*

#### Shareholding and Control

As of September 30, 2012, Sogou had outstanding a combined total of 220,639,750 ordinary shares and Series A Preferred Shares, consisting of:

- (i) 137,042,000 ordinary shares held by Sohu;
- (ii) 24,000,000 Series A Preferred Shares held by Sohu;
- (iii) 14,400,000 Series A Preferred Shares held by China Web;
- (iv) 38,400,000 Series A Preferred Shares held by Photon; and
- (v) 6,797,750 ordinary shares held by certain employees of Sogou and Sohu.

As of September 30, 2012, Sohu held 73% of the combined total of Sogou's outstanding ordinary shares and Series A Preferred Shares. As Sogou's controlling shareholder, Sohu consolidates Sogou in Sohu's consolidated financial statements but recognizes noncontrolling interest reflecting shares held by shareholders other than Sohu.

#### Dilutive Impact

As of September 30, 2012, a portion of the vested share options had been exercised. Because no ordinary shares will be issued with respect to share options granted by Sogou until they are vested and exercised, the Sogou shares underlying share options granted by Sogou that have not vested and vested share options that have not yet been exercised are not included as outstanding shares of Sogou and have no impact on Sohu's basic net income per share. Unvested share options with the performance targets achieved and vested share options that have not yet been exercised do, however, have a dilutive impact on Sohu's dilutive net income per share. See Note 15 - Net Income per Share.

#### Sogou Series A Terms

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

#### Dividend Rights

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

#### Liquidation Rights

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

#### Redemption Rights

The Series A Preferred Shares are not redeemable.

#### Conversion Rights

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

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### Voting Rights

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

### Other Rights

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

### **17173 Transaction**

On December 15, 2011, pursuant to an agreement entered into on November 29, 2011, Sohu closed the sale to Changyou of certain assets associated with the business of 17173.com (the "17173 Business"), a leading game information portal in China, for fixed cash consideration of \$162.5 million. As part of settlement of the consideration, Changyou.com HK Limited delivered to Sohu.com Limited a promissory note in the amount of \$16 million due on November 30, 2012. In connection with this transaction, Sohu and Changyou revised the Non-Competition Agreement between Sohu and Changyou to provide Sohu's agreement not to compete with Changyou in the 17173 Business for a period of five years following the closing of Changyou's acquisition of the 17173 Business and to remove the prior prohibition on Changyou's competing with Sohu in the 17173 Business. After the closing of the sale, Sohu continued to consolidate the results of operations of the 17173 Business in our consolidated financial statements.

On November 29, 2011, Sohu and Changyou entered into a services agreement and an online links and advertising agreement pursuant to which Sohu agreed to provide links and advertising space and technical support to Changyou, including the provision and maintenance of user log-in, information management and virtual currency payment systems. The agreements provide for a term of 25 years for the virtual currency payment system services, and an initial term of three years for all the other relevant services and links and advertising space, with aggregate fees payable by Changyou to Sohu of approximately \$30 million. Under the agreements, Changyou may renew certain rights for a subsequent term of 22 years, and may obtain a perpetual software license in respect of the information management system and the user log-in system following the expiration of the three-year term, subject to Changyou's payment to Sohu of additional fees of up to approximately \$5 million in the aggregate.

### **7Road Transactions**

On May 11, 2011, Changyou, through its VIE Gamease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road's financial statements on June 1, 2011. Effective June 26, 2012, Shenzhen 7Road was reorganized into a Cayman Islands holding company structure where Changyou holds a direct ownership interest in 7Road through Changyou's subsidiary Changyou.com Webgame (HK) Limited, and Shenzhen 7Road is a VIE of 7Road. For purposes of clarity, as the reorganization did not result in any change in the ultimate beneficial ownership of Shenzhen 7Road's business, assets and results of operations, when the Company discusses 7Road and Shenzhen 7Road in this report, it treats the reorganization as if it had been effective upon Changyou's acquisition of 68.258% of the equity interests in Shenzhen 7Road.

On June 21, 2012, 7Road's Chief Executive Officer surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the outstanding ordinary shares of 7Road, in order to increase the number of ordinary shares available for issuance as equity incentives to employees, directors and consultants of 7Road without dilution of the other shareholders of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou's interest in 7Road increased to 71.926%.

On September 26, 2012, 7Road submitted on a confidential basis to the SEC a draft registration statement for a possible IPO of ADSs representing ordinary shares of 7Road.

### **13. Mezzanine Equity**

On May 11, 2011, Changyou, through its VIE Gamease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road's financial statements on June 1, 2011. Effective June 26, 2012, Shenzhen 7Road was reorganized into a Cayman Islands holding company structure where Changyou holds a direct ownership interest in 7Road through Changyou's subsidiary Changyou.com Webgame (HK) Limited, and Shenzhen 7Road is a VIE of 7Road. For purposes of clarity, as the reorganization did not result in any change in the ultimate beneficial ownership of Shenzhen 7Road's business, assets and results of operations, when the Company discusses 7Road and Shenzhen 7Road in this report, it treats the reorganization as if it had been effective upon Changyou's acquisition of 68.258% of the equity interests in Shenzhen 7Road.

Mezzanine Equity consists of noncontrolling interest in 7Road and a put option pursuant to which the noncontrolling shareholders will have the right to put their equity interests in 7Road to Changyou at a pre-determined price if 7Road achieves specified performance milestones in the coming three years and certain circumstances occur. The put option will expire in 2014. Since the occurrence of the sale is not solely within the control of Changyou, the noncontrolling interest was classified as mezzanine equity instead of permanent equity in Sohu's and Changyou's consolidated financial statements.

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

On June 21, 2012, 7Road's Chief Executive Officer surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the outstanding ordinary shares of 7Road, in order to increase the availability of ordinary shares available for issuance as equity incentives to employees, directors and consultants of 7Road without dilution of the other shareholders of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou's interest in 7Road increased to 71.926%.

Under ASC *subtopic 480-10*, changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. The variance of \$6.8 million caused by 7Road's Chief Executive Officer's surrender of shares was recorded as a credit to additional paid-in capital.

In the third quarter of 2012, Changyou's management estimated that, based on 7Road's performance in the first three quarters of 2012, 7Road will likely exceed the specified performance milestones set forth in the acquisition agreement, and accordingly increased the estimated redemption value of the noncontrolling interests in 7Road. The increase in the redemption value was recognized over the period from the date of the 7Road acquisition to the earliest exercise date of the put right as net income attributable to mezzanine classified noncontrolling interests.

### **14. Noncontrolling Interest**

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

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

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

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

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

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

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

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

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

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

As of September 30, 2012 and December 31, 2011, noncontrolling interest in the consolidated balance sheets was \$205.3 million and \$210.6 million, respectively.

	As of	
	September 30, 2012 (in thousands)	December 31, 2011 (in thousands)
Changyou	\$ 176,931	\$ 163,704
Sogou	26,208	44,710
Others	2,191	2,232
Total	<u>\$ 205,330</u>	<u>\$ 210,646</u>

#### *Noncontrolling Interest of Changyou*

As of September 30, 2012 and December 31, 2011, \$176.9 million and \$163.7 million, respectively, noncontrolling interest was recognized in Sohu's consolidated balance sheets, representing a 32% and a 30%, respectively, economic interest in Changyou's net assets and reflected the reclassification of Changyou's share-based compensation expense from shareholders' additional paid-in capital to noncontrolling interest.

#### *Noncontrolling Interest of Sogou*

As of September 30, 2012 and December 31, 2011, \$26.2 million and \$44.7 million, respectively, noncontrolling interest was recognized in Sohu's consolidated balance sheets, representing Sogou's cumulative results of operations attributable to shareholders other than Sohu, Sogou's share-based compensation expenses, along with these shareholders' investments in the Series A Preferred Shares issued by Sogou.

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

For the three and nine months ended September 30, 2012, net income attributable to the noncontrolling interest in the consolidated statements of comprehensive income was \$21.1 million and \$57.6 million, respectively, compared with \$16.4 million and \$43.7 million, respectively, for the three months and nine months ended September 30, 2011.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Changyou	\$23,410	\$16,372	\$65,425	\$49,193
Sogou	(2,232)	(41)	(7,780)	(5,445)
Others	(32)	75	(27)	0
Total	<u>\$21,146</u>	<u>\$16,406</u>	<u>\$57,618</u>	<u>\$43,748</u>

#### *Noncontrolling Interest of Changyou*

For the three months ended September 30, 2012 and 2011, \$23.4 million and \$16.4 million, respectively, in net income attributable to the noncontrolling interest was recognized in Sohu's consolidated statements of comprehensive income, representing a 32% and a 31%, respectively, economic interest in Changyou attributable to shareholders other than Sohu.

#### *Noncontrolling Interest of Sogou*

For the three months ended September 30, 2012 and 2011, \$2,232,000 and \$41,000, respectively, in net loss attributable to the noncontrolling interest was recognized in Sohu's consolidated statements of comprehensive income, representing Sogou's net loss attributable to shareholders other than Sohu.

## 15. Net Income per Share

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

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

For the third quarter of 2012, the percentage used for the calculation of basic and dilutive net income per share was 68% and 67%, respectively. In the calculation of Sohu's diluted net income per share, all of Changyou's existing unvested restricted shares, unvested restricted share units, and vested restricted share units that have not yet been settled are treated as vested and settled by Changyou under the treasury stock method, causing the percentage of the weighted average number of shares held by Sohu in Changyou to decrease from 68% to 67%. As a result, Changyou's net income attributable to Sohu on a diluted basis decreased accordingly. This impact is presented as "incremental dilution from Changyou" in the table below.

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

In the calculation of Sohu's basic net income per share, Sogou's net income /(loss) attributable to Sohu is determined according to the Sogou Series A Terms, the terms of the restructuring and Sohu's purchase of Sogou Series A Preferred Shares from Alibaba. For the third quarter of 2012, in the calculation of Sohu's diluted net income per share, assuming a dilutive effect, the percentage of 73% was calculated by treating convertible preferred shares issued by Sogou as having been converted at the beginning of the period and unvested share options with the performance targets achieved as well as vested but unexercised share options as having been exercised during the period. The dilutive effect of share-based awards with a performance requirement was not considered before the performance targets were actually met. The above difference is presented as "incremental dilution from Sogou" in the table below.



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

	Three Months Ended		Nine Months Ended	
	September 30,	2011	September 30,	2011
	2012		2012	2011
<b>Numerator:</b>				
Net income attributable to Sohu.com Inc., basic	\$25,881	\$46,812	\$61,771	\$135,885
<b>Effect of dilutive securities:</b>				
Incremental dilution from Changyou	(510)	(1,532)	(1,945)	(5,166)
Incremental dilution from Sogou	(1,356)	(26)	(4,813)	(3,436)
Net income attributable to Sohu.com Inc., diluted	<u>\$24,015</u>	<u>\$45,254</u>	<u>\$55,013</u>	<u>\$127,283</u>
<b>Denominator:</b>				
Weighted average basic common shares outstanding	38,022	38,298	38,036	38,262
<b>Effect of dilutive securities:</b>				
Share options and restricted share units	322	546	356	562
Weighted average diluted common shares outstanding	<u>38,344</u>	<u>38,844</u>	<u>38,392</u>	<u>38,824</u>
Basic net income per share attributable to Sohu.com Inc.	<u>\$ 0.68</u>	<u>\$ 1.22</u>	<u>\$ 1.63</u>	<u>\$ 3.55</u>
Diluted net income per share attributable to Sohu.com Inc.	<u>\$ 0.63</u>	<u>\$ 1.17</u>	<u>\$ 1.44</u>	<u>\$ 3.28</u>

## 16. Subsequent Events

On November 2, 2012, the Board of Directors and the shareholders of 7Road approved an increase from 5,100,000 to 15,100,000 ordinary shares (amounting to 13.7% of the outstanding 7Road shares on a fully-diluted basis) in the number of ordinary shares available for issuance from time to time to selected directors, officers, employees, consultants and advisors of 7Road under its 2012 Share Incentive Plan.

The Company has performed an evaluation of subsequent events through the date the financial statements were issued, with no other material event or transaction needing recognition or disclosure found.

## 17. Recently Issued Accounting Pronouncements

In July 2012, the FASB issued revised guidance on "Testing Indefinite-Lived Intangible Assets for Impairment". The revised guidance applies to all entities, both public and nonpublic, that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. Under the revised guidance, an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform a quantitative impairment test by comparing the fair value with the carrying amount in accordance with Subtopic 350-30. An entity also has the option to bypass a qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. In conducting a qualitative assessment, an entity should consider the extent to which relevant events and circumstances, both individually and in the aggregate, could have affected the significant inputs used to determine the fair value of the indefinite-lived intangible asset since the last assessment. An entity also should consider whether there have been changes to the carrying amount of the indefinite-lived intangible asset when evaluating whether it is more likely than not that the indefinite-lived intangible asset is impaired. An entity should consider positive and mitigating events and circumstances that could affect its determination of whether it is more likely than not that the indefinite-lived intangible asset is impaired. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The Company is currently evaluating the impact on its consolidated financial statements of adopting this guidance.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

As used in this report, references to “us,” “we,” “our,” “our company,” “our group,” “Sohu” and “Sohu.com” are to Sohu.com Inc. and, except where the context requires otherwise, our wholly-owned and majority-owned subsidiaries and variable interest entities (“VIEs”), Sohu.com Limited, Sohu.com (Hong Kong) Limited (“Sohu Hong Kong”), All Honest International Limited, Sohu.com (Game) Limited (“Sohu Game”), Go2Map Inc., Sohu.com (Search) Limited, Sogou Inc., Sogou (BVI) Limited, Sogou Hong Kong Limited, Vast Creation Advertising Media Services Limited (“Vast Creation”), Fox Video Investment Holding Limited (“Video Investment”), Fox Video Limited (“Sohu Video”), Fox Video (HK) Limited (“Video HK”), Beijing Sohu New Era Information Technology Co., Ltd. (“Sohu Era”), Beijing Sohu Software Technology Co., Ltd. (“New Software”), Beijing Fire Fox Digital Technology Co., Ltd. (“Beijing Fire Fox”, also known as Beijing Huohu Digital Technology Co., Ltd., or “Huohu”), Beijing Sohu Interactive Software Co., Ltd. (“Sohu Software”), Go2Map Software (Beijing) Co., Ltd. (“Go2Map Software”), Beijing Sogou Technology Development Co., Ltd. (“Sogou Technology”), Beijing Sogou Network Technology Co., Ltd. (“Sogou Network”), Fox Information Technology (Tianjin) Limited (“Video Tianjin”), Beijing Sohu New Media Information Technology Co., Ltd. (“Sohu Media”), Beijing Focus Time Advertising Media Co., Ltd. (“Focus Time”), Beijing Sohu New Momentum Information Technology Co., Ltd. (“Sohu New Momentum”), Beijing Century High Tech Investment Co., Ltd. (“High Century”), Beijing Sohu Entertainment Culture Media Co., Ltd. (“Sohu Entertainment”, formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd., or “Hengda”), Beijing Sohu Internet Information Service Co., Ltd. (“Sohu Internet”), Beijing GoodFeel Information Technology Co., Ltd. (“GoodFeel”), Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (“Tu Xing Tian Xia”), Beijing Sogou Information Service Co., Ltd. (“Sogou Information”), Beijing 21 East Culture Development Co., Ltd. (“21 East Beijing”), Beijing Sohu Donglin Advertising Co., Ltd. (“Donglin”), Beijing Pilot New Era Advertising Co., Ltd. (“Pilot New Era”), Beijing Focus Yiju Network Information Technology Co., Ltd. (“Focus Yiju”), Beijing Yi He Jia Xun Information Technology Co., Ltd. (“Yi He Jia Xun”), Beijing 17173 Network Technology Co., Ltd. (“17173 Network”), Tianjin Jinhua Culture Development Co., Ltd. (“Tianjin Jinhua”) and our independently-listed majority-owned subsidiary Changyou.com Limited (“Changyou”, formerly known as TL Age Limited) as well as the following direct and indirect subsidiaries and VIEs of Changyou: Changyou.com HK Limited (“Changyou HK”, formerly known as TL Age Hong Kong Limited), Changyou.com Webgame (HK) Limited (“Changyou HK Webgame”), Changyou.com Gamepower (HK) Limited (“Changyou HK Gamepower”), ICE Entertainment (HK) Limited (“ICE HK”), Changyou.com (US) Inc. (formerly known as AmazGame Entertainment (US) Inc.), Changyou.com (UK) Company Limited (“Changyou UK”), ChangyouMy Sdn. Bhd (“Changyou Malaysia”), Changyou.com Korea Limited (“Changyou Korea”), Changyou.com India Private Limited (“Changyou India”), Changyou BİLİŞİM HİZMETLERİ TİCARET LİMİTED ŞİRKETİ (“Changyou Turkey”), Kylie Enterprises Limited, 7Road.com Limited (“7Road”), 7Road.com HK Limited (“7Road HK”), Beijing AmazGame Age Internet Technology Co., Ltd. (“AmazGame”), Beijing Changyou Gamespace Software Technology Co., Ltd. (“Gamespace”), ICE Information Technology (Shanghai) Co., Ltd. (“ICE Information”), Beijing Yang Fan Jing He Information Consulting Co., Ltd. (“Yang Fan Jing He”), Shanghai Jingmao Culture Communication Co., Ltd. (“Shanghai Jingmao”), Shanghai Hejin Data Consulting Co., Ltd. (“Shanghai Hejin”), Beijing Jingmao Film & Culture Communication Co., Ltd. (“Beijing Jingmao”), Beijing Gamease Age Digital Technology Co., Ltd. (“Gamease”), Beijing Guanyou Gamespace Digital Technology Co., Ltd. (“Guanyou Gamespace”), and Shanghai ICE Information Technology Co., Ltd. (“Shanghai ICE”), Shenzhen 7Road Network Technologies Co., Ltd. (“7Road Technology”), Shenzhen 7Road Technology Co., Ltd. (“Shenzhen 7Road”), and these references should be interpreted accordingly. Unless otherwise specified, references to “China” or “PRC” refer to the People’s Republic of China and do not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words “expect”, “anticipate”, “intend”, “believe”, or similar language. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our business and financial performance are subject to substantial risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information set forth under the heading “Risk Factors” in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission (“SEC”) on February 28, 2012, as updated by Part II Item 1A of this report. Readers are cautioned not to place undue reliance on these forward-looking statements.

## OVERVIEW

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

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

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

The Internet and Internet-related markets in China continued to evolve rapidly during 2012. According to a semiannual report issued by the China Internet Network Information Center (“CNNIC”), the total number of Internet users in China had reached 538 million by the end of June 2012, an increase of 24.5 million from the end of 2011. The number of mobile Internet users in China had reached 388 million by the end of June 2012, an increase of 32.7 million from the end of 2011, and exceeding the 380 million desktop computer Internet users as of June 2012. Mobile Internet is becoming the top channel for Internet users to access Websites in China. We believe that this large and expanding user base will continue to provide significant opportunities for our company to expand our product offerings and to explore new revenue streams.

However, China’s economy has been experiencing decelerating growth recently, with the result that many large advertisers were cautious regarding their spending on advertising in the face of this economy uncertainty. At the same time, we have been facing fierce competition arising from existing and new Internet companies, which have been seizing advertising market share. We have noted that this macro-economic environment and increased competition has had some adverse impact on our brand advertising business.

In China, online video is a popular Internet application, with over 350 million users as of June 30, 2012 according to the semiannual report issued by CNNIC. We expect that brand in the future will continue to allocate more advertising dollars to online video in order to exploit this growing market, but we are uncertain as to when such an increased allocation will occur, or how large it might be. The market prices of online video content are becoming relatively stable after a significant decline in prior months. During the third quarter of 2012, our strategic plan of building a dedicated sales team was well on track, and our video direct account sales team was in place. Also, we set up a video agency sales team during quarter. We are optimistic about the prospects of our online video business, and expect this business to resume on a growth track during the fourth quarter of 2012.

In the third quarter, our search and others business continued to grow, which was attributable to the growth of pay-for-click services, as well as online marketing services on Sogou Web Directory. We expect our search and others business will sustain healthy revenue growth through the remainder of 2012.

We continue to be pleased with, and optimistic regarding, the growth and profitability of our online games business. We believe that our strong performance in the third quarter reflects the resilience of the online games industry in China despite the weakening global macroeconomic environment and economic slowdown in China, and that it also reflects the ongoing strength of our online games content and our successful expansion into other fast-growing segments of the industry, such as web games.

We believe, as discussed above, that there are significant opportunities to explore new revenue streams related to the mobile Internet market. Our wireless business faces a challenge in this regard, as we will need to catch up with our peer competitors with respect to penetration of new mobile applications and features.

### **Summary of Our Business**

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

##### *Brand Advertising Business*

Our brand advertising business offers various products and services (such as free of charge premier content including video content, interactive community, and other competitive Internet services) to our users, and provides advertising services to advertisers on our matrices of Chinese language Web properties consisting of:

- sohu.com, a leading mass portal and online media destination;
- focus.cn, a top real estate Website; and
- 17173.com, a leading game information portal. Since December 15, 2011, 17173.com has been owned and operated by our majority-owned subsidiary Changyou.com Limited (“Changyou”).

Our brand advertising business offers advertisements on our Web properties to companies seeking to increase their brand awareness online.

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### *Search and Others Business*

Our search and others business, provided by our search subsidiary Sogou Inc. (“Sogou”), primarily offers customers pay-for-click services, as well as online marketing services on Sogou Web Directory.

### *Online Game Business*

Our online game business is conducted via Changyou, which is a leading online game developer and operator in China. Changyou engages in the development, operation and licensing of online games, including massively multiplayer online games (“MMOGs”) and Web games. Changyou developed and operates Tian Long Ba Bu (“TLBB”), which is one of the most popular MMOGs in China. Changyou’s majority-owned subsidiary 7Road.com Limited (“7Road”) jointly operates DDTank and Wartune (also known as “Shen Qu”), which are two popular Web games in China, primarily through an extensive network of third-party game platforms in China and overseas.

For the third quarter of 2012, more than 71% of the revenues of our online game business were derived from TLBB. Changyou’s online game revenues were \$151.1 million, which represented 53% of our total revenues for the quarter. Net income contributed by Changyou for the quarter was \$77.4 million, which represented 150% of our total net income. We depend on Changyou for a significant portion of our revenues, net income, and operating cash flow.

### *Wireless Business*

Our wireless business offers mobile related services through different types of wireless products to mobile phone users. The mobile related services consist of the provision of content such as news, weather forecasts, chatting, entertainment information, mobile games, mobile phone ringtones, logo downloads and video content downloads. A majority of the content is purchased from third party content providers. The wireless products mainly consist of short messaging services (“SMS”), interactive voice response (“IVR”), mobile games and Ring Back Tone (“RBT”).

### *Others Business*

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

### *Business Restructuring*

#### *Initial Public Offering of Changyou*

On April 7, 2009, Changyou completed its initial public offering on the NASDAQ Global Select Market, trading under the symbol “CYOU.” After Changyou’s offering, as we are Changyou’s controlling shareholder, we continue to consolidate Changyou in our consolidated financial statements, but recognize noncontrolling interest reflecting shares held by shareholders other than us. For the third quarter of 2012, approximately 32% of the economic interest in Changyou was recognized as noncontrolling interest in our consolidated financial statements.

On August 6, 2012, Changyou declared a special one-time cash dividend of \$1.90 per Class A or Class B ordinary share, or \$3.80 per American depositary share (“ADS”) and a total of \$201 million. On September 21, 2012, Changyou paid out this special cash dividend, of which \$136 million was paid to and received by Sohu.

We have entered into agreements with Changyou with respect to various interim and ongoing relationships between us, including a Master Transaction Agreement, a Revised Non-Competition Agreement, and an Amended and Restated Marketing Services Agreement. These agreements contain provisions which, among other things, relate to the transfer of assets and assumption of liabilities of the massively multiplayer online role-playing game (“MMORPG,” which is a subset of the MMOG category) business, provide cross-indemnification between us and Changyou for liabilities arising from our respective businesses and mutually limit us and Changyou from competing in certain aspects of each other’s businesses, and also include a number of ongoing commercial relationships.

#### *Sogou Transactions*

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

On June 29, 2012, Sohu purchased the 24.0 million Sogou Series A Preferred Shares held by Alibaba for fixed cash consideration of \$25.8 million. After the purchase of these shares, we held 73% of the combined total of Sogou’s outstanding ordinary shares and Series A Preferred Shares. As we are Sogou’s controlling shareholder, we continue to consolidate Sogou in our consolidated financial statements, but recognize noncontrolling interest reflecting shares held by shareholders other than us.

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### **17173 Transaction**

On December 15, 2011, pursuant to an agreement entered into on November 29, 2011, we closed the sale to Changyou of certain assets associated with the business of 17173.com (the “17173 Business”), a leading game information portal in China, for fixed cash consideration of \$162.5 million. In payment of part of the consideration, Changyou.com HK Limited delivered to Sohu.com Limited a promissory note in the amount of \$16 million due on November 30, 2012. In connection with this transaction, we and Changyou revised the Non-Competition Agreement between us to provide our agreement not to compete with Changyou in the 17173 Business for a period of five years following the closing of Changyou’s acquisition of the 17173 Business and to remove the prior prohibition on Changyou’s competing with us in the 17173 Business. After the closing of the sale, we continued to consolidate the results of operations of the 17173 Business in our consolidated financial statements.

On November 29, 2011, we and Changyou entered into a services agreement and an online links and advertising agreement pursuant to which we agreed to provide links and advertising space and technical support to Changyou, including the provision and maintenance of user log-in, information management and virtual currency payment systems for the 17173 Business. The agreements provide for a term of 25 years for the virtual currency payment system services, and an initial term of three years for all the other relevant services and links and advertising space, with aggregate fees payable by Changyou to us of approximately \$30 million. Under the agreements, Changyou may renew certain rights for a subsequent term of 22 years, and may obtain a perpetual software license in respect of the information management system and the user log-in system following the expiration of the three-year term, subject to Changyou’s payment to us of additional fees of up to approximately \$5 million in the aggregate.

### **7Road Transactions**

On May 11, 2011, Changyou, through its VIE Gameease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road’s financial statements on June 1, 2011. Effective June 26, 2012, Shenzhen 7Road was reorganized into a Cayman Islands holding company structure where Changyou holds a direct ownership interest in 7Road through Changyou’s subsidiary Changyou.com Webgame (HK) Limited, and Shenzhen 7Road is a VIE of 7Road. For purposes of clarity, as the reorganization did not result in any change in the ultimate beneficial ownership of Shenzhen 7Road’s business, assets and results of operations, when we discuss 7Road and Shenzhen 7Road in this report, we treat the reorganization as if it had been effective upon Changyou’s acquisition of 68.258% of the equity interests in Shenzhen 7Road.

On June 21, 2012, 7Road’s Chief Executive Officer surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the outstanding ordinary shares of 7Road, in order to increase the number of ordinary shares available for issuance as equity incentives to employees, directors and consultants of 7Road without dilution of the other shareholders of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou’s interest in 7Road increased to 71.926%.

On September 26, 2012, 7Road submitted on a confidential basis to the SEC a draft registration statement for a possible initial public offering (“IPO”) of ADSs representing ordinary shares of 7Road.

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

Our discussion and analysis of our financial condition and results of operations relates to our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing 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 have identified below the accounting policies that reflect our more significant estimates and judgments, and those that we believe are the most critical to fully understanding and evaluating our consolidated financial statements.

### **Basis of Consolidation**

The consolidated financial statements include the accounts of Sohu and its wholly-owned and majority-owned subsidiaries and variable interest entities (“VIEs”). All intercompany transactions are eliminated.

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

For majority-owned subsidiaries and VIEs, noncontrolling interest is recognized to reflect the portion of their equity which is not attributable, directly or indirectly, to the controlling shareholder.

### **Revenue Recognition**

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

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

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

For a barter transaction involving online advertising services, we recognize revenue and expense at fair value only if the fair value of the advertising services surrendered /received in the transaction is determinable. For our advertising-for-advertising barter transactions, the fair value of the advertising surrendered /received is not determinable, so no revenue from advertising-for-advertising barter transactions is recognized.

Before September 1, 2012, our online advertising revenues were subject to PRC business tax ("Business Tax"). Our online advertising revenues were recognized after deducting agent rebates and applicable Business Tax and related surcharges. Business Tax is imposed primarily on revenues from the provision of taxable services and is calculated by multiplying the applicable tax rate by gross revenue.

Effective September 1, 2012, the PRC Ministry of Finance and the State Administration of Taxation launched a Business Tax to Value Added Tax Transformation Pilot Program (the "Pilot Program") for certain industries in eight regions, including Beijing and Tianjin. Value Added Tax ("VAT") payable on goods sold or taxable labor services provided by a general VAT taxpayer for a taxable period is the net balance of the output VAT for the period after crediting the input VAT for the period. Hence, the amount of VAT payable does not result directly from output VAT generated from goods sold or taxable labor services provided. With the adoption of Pilot Program, our online advertising revenues are subject to VAT. Our online advertising revenues are now recognized after deducting agent rebates and net of VAT and related surcharges.

#### ***Brand Advertising Revenues***

##### **Business Model**

Currently the brand advertising business has two main types of pricing models, consisting of the Fixed Price Model and the Cost Per Impression ("CPM") pricing model. We apply the Fixed Price Model for a majority of our brand advertising revenues. Under the Fixed Price Model, a contract is signed to establish a fixed price for the advertising services to be provided. Under the CPM pricing model, the total contract amount for the advertising services is not fixed. Instead, a fixed price for each qualifying display is stated. Advertisers using the CPM pricing model pay us based on the number of qualifying displays of their advertisements appear on our Websites, and we recognize as revenue the fees charged to advertisers each time their advertisements are displayed on the Websites, on the condition that each display meets certain selected criteria imposed by advertisers. We provide advertisement placements to our advertisers on our different Website channels and in different formats, which can include, among other things, banners, links, logos, buttons, rich media, pre-roll and post-roll video screens, pause video screens and content integration, as specified in the contracts with the advertisers.

##### **Revenue recognition and basis of revenue presentation**

For brand advertising revenue recognition, prior to entering into contracts, we make a credit assessment of the customer to assess the collectability of the contract. For those contracts for which the collectability is determined to be reasonably assured, we recognize revenue when all revenue recognition criteria are met. For those contracts for which the collectability is determined not to be reasonably assured, we recognize revenue only when the cash was received and all other revenue recognition criteria are met.

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

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We recognize gross revenue for the amount of fees we receive from our advertisers. Determining whether revenue should be reported gross or net is based on an assessment of various factors, the primary factor is whether we are acting as the principal in offering services to the customer or we are acting as an agent in the transaction. For the brand advertising business, we recognize net revenue for the transactions where we act as an agent. Whether we are serving as principal or agent in a transaction is judgmental in nature and is determined by evaluating the terms of the arrangement.

### *Search and Others Revenues*

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

#### *Pay-for-click services*

Pay-for-click services mainly consist of search query-based and contextual online marketing services. Search query-based online marketing services are keyword-based marketing services. Our auction-based system enables advertisers, on a real time basis, to bid on keywords that trigger the display of their Website links on Sogou search result pages. The display priority of advertiser Website links is based on both the price bid on the keyword and the quality factor of an advertiser's Website link for that search query. Revenue for pay-for-click services is recognized on a per click basis when the users click on the displayed links.

Contextual online marketing services enable our advertisers' promotional links to be displayed on Sogou Website Alliance members' Websites where the links are relevant to the subject and content of such Web pages.

#### *Online marketing services on Sogou Web Directory*

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

#### *Sogou Website Alliance*

Both pay-for-click services and online marketing services on Sogou Web Directory involve the Sogou Website Alliance. The Sogou Website Alliance is a program through which we expand distribution of our advertisers' Website links or advertisements by leveraging traffic on Sogou Website Alliance members' Websites. Payments made to Sogou Website Alliance members are included in cost of search and others revenues as traffic acquisition costs. We pay Sogou Website Alliance members either based on revenue-sharing arrangements, under which we pay a percentage of pay-for-click revenues generated from clicks by users of their properties, or based on a pre-agreed unit price.

#### *Basis of revenue presentation*

We recognize gross revenue for the amount of fees we receive from our advertisers. Determining whether revenue should be reported gross or net is based on an assessment of various factors, the primary factor is whether we are acting as the principal in offering services to the customer or we are acting as an agent in the transaction. For pay-for-click services, we recognize gross revenue, as we have the primary responsibility for fulfillment and acceptability. As there is no revenue sharing for online marketing services on Sogou Web Directory, there is no need to make a gross versus net judgment. Whether we are serving as principal or agent in a transaction is judgmental in nature and is determined by evaluating the terms of the arrangement.

### *Online Game Revenues*

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

#### *MMOG operations revenues*

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

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

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

### *Web game revenue*

We generated Web game revenues for the first time in 2011, upon Changyou's acquisition of a majority interest in 7Road. 7Road's Web games are designed to be operated under the item-based revenue model. 7Road primarily jointly operates its games with third-party operators who offer the game to users in China and other countries through their Websites or platforms.

7Road's joint operation arrangements with third parties provide for two revenue streams, an initial fixed license fee and monthly joint operation revenue sharing. Since 7Road is required to provide when-and-if-available upgrades to the joint operators over the joint operation period, the initial license fee is recognized ratably as revenue over the contract period. Since the third-party operator is the party that signs the user agreement with its users and is responsible for its users' experience on its Websites or platforms, 7Road does not have the primary responsibility for fulfillment and acceptability of the game services and is not considered a principal in the transactions with the users, and therefore recognizes revenues on a net basis.

For arrangements where 7Road's games are hosted on third-party joint operator's servers, revenues are recognized upon the conversion of the virtual currency of the joint operator into 7Road's game coins or, if such operator does not have its own virtual currency, upon payment by the game players for the purchase of 7Road's game coins through such joint operator's Website and game platform. However, when 7Road also provides server hosting services to its joint operators for its games, revenues are allocated to two separate elements, including (i) the game and related service element and (ii) the hosting service element. Revenues allocated to the game and related service element are recognized upon conversion by game players of the joint operator's virtual currency into 7Road's game coins or payment by game players for 7Road's game coins through such operator's Website and game platform. Revenues allocated to the hosting service element are recognized over the implicit service period during which 7Road is obligated to provide access to the server for the game players to be able to consume their virtual items. Accordingly, for consumable virtual items, revenues are recognized when the virtual items are consumed or over the predetermined period of use, or benefit period, and for perpetual virtual items revenues are recognized over the estimated average period the game players play 7Road's games.

### *Overseas licensing revenue*

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



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### **Wireless Revenues**

Our wireless revenues are generated from the provision of mobile-related services through different types of wireless products to mobile phone users. The wireless products mainly consist of SMS, IVR, mobile games and RBT. In order to deliver our products to mobile phone users, we sign contracts with China Mobile Communications Corporation (“China Mobile”), China United Network Communication Group Company Limited (“China Unicom”), China Telecom Corporation (“China Telecom”) and their subsidiaries, as well as other small mobile network operators. We refer to these mobile network operators, collectively, as the “China mobile network operators.” The China mobile network operators charge their users wireless service fees on a monthly or per message /download basis, and pay us service fees after deducting the China mobile network operators’ share of the fees.

Wireless revenues are recognized in the month in which the service is performed, provided that no significant obligations remain. For the amount of revenues to be recognized, we rely on billing confirmations issued by the China mobile network operators. If at the end of each reporting period, an operator has not yet issued such billing confirmations, we estimate the amount of collectable wireless service fees and recognize revenue. When we later receive billing confirmations, we record a true-up accounting adjustment. For the three months ended September 30, 2012, 70% of our estimated wireless revenues were confirmed by billing confirmations received from the China mobile network operators. Generally, (i) within 15 to 120 days after the end of each month, we receive billing confirmations from the operators and (ii) within 30 to 180 days after delivering billing confirmations, each operator remits the wireless service fees, net of its service fees, to us.

Currently, a majority of our wireless revenues are recorded on a gross basis, as we have the primary responsibility for fulfillment and acceptability of the wireless services.

### **Others Revenues**

Other revenues are primarily generated from sub-licensing of licensed video content operated by Sohu, cinema advertisements operated by Changyou and IVAS provided by Sogou with respect to Web games developed by third-party developers.

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

For licensed video content purchased with payment in cash on an exclusive basis, we have rights to sub-license to other platforms. Revenue from sub-licensing of licensed video content is recognized when the following criteria are met:

- (1) Persuasive evidence of a sub-licensing arrangement exists;
- (2) The content has been delivered or is available for immediate and unconditional delivery;
- (3) The sub-license period as indicated in the arrangement has begun and the sub-licensee can begin its exploitation (exhibition); and
- (4) The sub-licensing fee is fixed or determinable and collection of the sub-licensing fee is reasonably assured.

#### *Revenue from cinema advertisements*

For cinema advertising revenues, a contract is signed with the advertiser to establish a fixed price and specify advertising services to be provided. Based on the contracts, we provide advertisement placements in advertising slots to be shown in theatres before the screening of movies. The rights to place advertisements in such advertising slots are granted under contracts with different theatres and film production companies.

Revenue from cinema advertising is recognized when all the recognition criteria are met. Depending on the terms of a customer contract, fees for services performed can be recognized according to two principal methods, which are the proportional performance method and the straight-line method. Under the proportional performance method, fees are generally recognized based on a percentage of the advertising slots actually delivered where the fee is earned on a per-advertising slot placement basis. Under the straight-line method, fees are recognized on a straight-line basis over the contract period when the fee is not paid based on the number of advertising slots actually delivered.

#### *Revenue from IVAS*

We, through Sogou, offer Web games developed by third-party developers and generate revenue from the provision of Internet value-added services, including promotion, access maintenance and payment services to third-party developers. The online games can be accessed and played by end users free of charge but the end users may choose to purchase in-game merchandise to enhance their game playing experience.

Under revenue sharing agreements signed with third-party developers, we collect payments from the end users for items sold, keep a pre-agreed percentage of the proceeds and remit the balance to the third-party developers. Revenue from IVAS is recognized when our obligations under the agreements and all other revenue recognition criteria have been met.

## Share-based Compensation Expense

Sohu, Changyou, Sogou, Sohu Video and 7Road all have incentive plans for the granting of share-based awards, including common stock /ordinary shares, share options, restricted shares and restricted share units, to their executive officers, management and employees. Share-based compensation expense is recognized as costs and /or expenses in the consolidated statements of comprehensive income based on the fair value of the related share-based awards on their grant dates.

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

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

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

On January 4, 2012, Sohu Video, the holding entity of Sohu's video division, adopted a 2011 Share Incentive Plan which provided for the issuance of up to 25,000,000 ordinary shares of Sohu Video (amounting to 10% of the outstanding Sohu Video shares on a fully-diluted basis) to management and key employees of the video division and to Sohu management. As of September 30, 2012, grants of options for the purchase of 15,352,200 of ordinary shares of Sohu Video had been made and were effective under the plan. However, as of September 30, 2012, the restructuring of Sohu's video division was still in process and certain significant factors remained uncertain. For purposes of ASC 718, no grant date is established until mutual understanding of the option awards' key terms and conditions between Sohu Video and the recipients can be reached, and such mutual understanding cannot be reached until the video division's restructuring plan has been substantially fixed, so that the enterprise value of Sohu Video and hence the fair value of the options is determinable and can be accounted for. As of September 30, 2012, on the basis that the broader terms and conditions of the option awards had neither been finalized nor mutually agreed with the recipients, no grant of options had occurred for purposes of ASC 718 and hence no share based compensation expense was recognized.

On July 10, 2012, 7Road adopted a 2012 Share Incentive Plan (the "7Road 2012 Share Incentive Plan"), which initially provided for the issuance of up to 5,100,000 ordinary shares of 7Road (amounting to 5.1% of the outstanding 7Road shares on a fully-diluted basis) to selected directors, officers, employees, consultants and advisors of 7Road. On November 2, 2012, 7Road's Board of Directors and its shareholders approved an increase from 5,100,000 to 15,100,000 ordinary shares (amounting to 13.7% of the outstanding 7Road shares on a fully-diluted basis) in the number of ordinary shares available for issuance from time to time to selected directors, officers, employees, consultants and advisors of 7Road under its 2012 Share Incentive Plan. As of September 30, 2012, 2,546,250 restricted share units had been granted under the plan. Such restricted share units will not be vested until 7Road's completion of a firm commitment underwritten IPO of its shares resulting in a listing on an internationally recognized exchange and the expiration of all underwriters' lockup periods applicable to the IPO. The completion of a firm commitment IPO is considered to be a performance condition of the awards. An IPO event is not considered to be probable until it is completed. Under ASC 718, compensation cost should be accrued if it is probable that the performance condition will be achieved and should not be accrued if it is not probable that the performance condition will be achieved. As a result, no compensation expense will be recognized relating to these restricted share units until the completion of an IPO, and hence no share-based compensation expense was recognized for the quarter ended September 30, 2012.

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

The assumptions used in share-based compensation expense recognition represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. If factors change or different assumptions are used, our share-based compensation expense could be materially different for any period. Moreover, the estimates of fair value are not intended to predict actual future events or the value that ultimately will be realized by employees who receive equity awards, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by us for accounting purposes.

## **Taxation**

### ***Income Taxes***

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

Our deferred tax assets are related to net operating losses and temporary differences between accounting basis and tax basis for our China-based subsidiaries and VIEs that are subject to corporate income tax in the PRC under the PRC Corporate Income Tax Law.

### ***Withholding tax***

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

In 2012, Changyou's Board of Directors determined to cause one of Changyou's PRC subsidiaries to distribute all of its 2012 earnings to its overseas parent company, Changyou.com HK Limited ("Changyou HK"). Based on an assessment performed pursuant to requirements specified by PRC tax authorities, Changyou concluded that it was more likely than not that such distribution would be subject to 5% withholding tax. For the nine months ended September 30, 2012, Changyou accrued deferred tax liabilities in the amount of \$8.7 million for withholding taxes associated with this distribution plan.

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

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

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

Effective September 1, 2012, a pilot program for transition from the imposition of Business Tax to the imposition of VAT for revenues from certain industries was expanded from Shanghai to eight other cities and provinces in China, including Beijing and Tianjin. Our brand advertising and search revenues are subject to this program.

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

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

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

The implementation of the pilot program has not had a significant impact on our consolidated statements of comprehensive income for the three and nine months ended September 30, 2012.

### **Noncontrolling Interest**

Noncontrolling interest is the portion of economic interest in Sohu's majority-owned subsidiaries and VIEs which is not attributable, directly or indirectly, to Sohu. Currently, the noncontrolling interest in our consolidated financial statements mainly consists of noncontrolling interest for Changyou and Sogou.

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

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

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

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

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

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

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

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

### **Net Income per Share**

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

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

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

Our financial instruments include cash equivalents, restricted time deposits, short-term investments, accounts receivable, investments in debt securities, prepaid and other current assets, accounts payable, short-term bank loans, accrued liabilities, receipts in advance and deferred revenue, other short-term liabilities and long-term bank loans. The carrying amount of accounts receivable, prepaid and other current assets, accounts payable, receipts in advance and deferred revenue, accrued liabilities and other short-term liabilities approximates their fair value. Other financial instruments are measured at their respective fair values. For fair value measurements, U.S. GAAP establishes a three-tier hierarchy which prioritizes the inputs used in the valuation methodologies in measuring fair value:

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

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

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

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

### **Cash Equivalents**

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

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

In the third quarter of 2012, Changyou drew down offshore bridge loans from branches of certain banks for the purposes of expediting the payment of the special one-time cash dividend to its shareholders and providing working capital to support its overseas operations. All of these bridge loans were secured by an equivalent or greater amount in RMB deposits by Changyou in the onshore branches of such banks.

The offshore bridge loans from the branches of the lending banks are classified as short-term bank loans or long-term bank loans based on their payment terms. The RMB onshore deposits securing the offshore loans are treated as restricted time deposits on our consolidated balance sheets. Restricted time deposits are valued based on the prevailing interest rates in the market. The rates of interest under the loan agreements with the lending banks were also determined based on the prevailing interest rates in the market. We classify the valuation techniques that use these inputs as Level 2 of fair value measurements of offshore bridge loans from banks.

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### **Short-term Investments**

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

### **Accounts Receivable, Net**

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

### **Investments in Debt Securities**

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

### **Equity Investments**

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

### **Long-Lived Assets**

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

#### **Fixed Assets**

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

#### **Intangible Assets**

Intangible assets mainly comprise customer lists, video content and license, developed technologies, computer software purchased from unrelated third parties, domain names and trademarks, marketing rights and others, as well as operating rights for licensed games. Intangible assets are recorded at cost less accumulated amortization with no residual value. Amortization of intangible assets other than licensed video content is computed using the straight-line method over their estimated useful lives. We amortize licensed video content over the shorter of the term of the estimated period over which the benefits of the license agreement will be enjoyed based on the trend of accumulation of viewership or the applicable license period. Beginning in the third quarter of 2011, licensed video content is amortized on an accelerated basis based on the viewership accumulation trend over the shorter of the term of the estimated period over which the benefits of the license agreement will be enjoyed or the applicable license period.

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For exclusively licensed video content which we sub-licensed to similar platforms in return for payment in cash, we allocate a portion of the video content cost from cost of brand advertising revenues to sub-licensing cost. The allocation is based on the revenues to be generated through sub-licensing. We amortize sub-licensing cost using the individual-film-forecast-computation method, which amortizes such costs in the same ratio that actual sub-licensing revenue bears as of the current period end to the total of the actual revenue earned and the estimated remaining unrecognized ultimate revenue.

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

Prepaid non-current assets primarily include prepayments for the office buildings to be built as our and Changyou's headquarters before they are recognized as fixed assets, prepayments for the technological infrastructure and fitting-out of our office building before they are recognized as fixed assets, and prepaid PRC income tax arising from the sale of the 17173 Business by us to Changyou. Since the sale of the 17173 Business was between entities that are included in our consolidated financial statements, it was considered an "intra-entity transaction" and, under ASC 810-10, income taxes paid should be deferred. Accordingly, we recorded income tax related to the sale of the 17173 Business as prepaid PRC income tax. The prepaid PRC income tax will be amortized over the period of the weighted average remaining life of the 17173 Business-related assets sold to Changyou.

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

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

We noted that prices for purchased video content decreased significantly in the second quarter of 2012. We considered this is an indicator of impairment, and accordingly we performed an impairment test for our purchased video content at the asset group level. We divided purchased video content into seven asset groups, consisting of TV series, Pay Channel, Overseas Content, Movies, Animations, Variety shows, and Documentary films. We tested the recoverability of the carrying values of these asset groups by comparing their carrying amounts to the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset groups. If the carrying amount of an asset group was determined to not be recoverable, an impairment loss was recognized, measured by comparing the carrying value of the asset group to the asset group's fair value. The fair values of the purchased video content were estimated using the discounted cash flow method. The impairment losses were allocated only to the purchased video content within the asset group, since the carrying amount of other long-lived assets within the asset group was considered to be already below their fair value.

### **Goodwill**

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

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

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

### **Contingent Consideration**

Our contingent consideration primarily consisted of contingent payments generated from the acquisition of 7Road. The acquisition of 7Road includes a contingent consideration arrangement that requires additional consideration to be paid by Changyou based on the future financial performance of 7Road through December 31, 2012. The fair value of the contingent consideration recognized on the acquisition date was estimated using the income approach. As of September 30, 2012, certain specified performance milestones in 2012 had been achieved by 7Road based on its nine months' financial performance, and we recorded consideration payable of \$19.7 million in other accrued liabilities. Changes in fair value of the contingent consideration were recognized in other income/(expense). There are no indemnification assets involved.

### **Mezzanine Equity**

On May 11, 2011, Changyou, through its VIE Gamease, acquired 68.258% of the equity interests of Shenzhen 7Road and began to consolidate Shenzhen 7Road's financial statements on June 1, 2011. Effective from June 26, 2012, Shenzhen 7Road was reorganized into a Cayman Islands holding company structure where Changyou holds a direct ownership interest in 7Road through Changyou's subsidiary Changyou.com Webgame (HK) Limited, and Shenzhen 7Road is a VIE of 7Road. For purposes of clarity, as the reorganization did not result in any change in the ultimate beneficial ownership of Shenzhen 7Road's business, assets and results of operations, when we discuss 7Road and Shenzhen 7Road in this report, we treat the reorganization as if it had been effective upon Changyou's acquisition of 68.258% of the equity interests in Shenzhen 7Road.

Mezzanine Equity consists of noncontrolling interest in 7Road and a put option pursuant to which the noncontrolling shareholders will have the right to put their equity interests in 7Road to Changyou at a pre-determined price if 7Road achieves specified performance milestones in the coming three years and certain circumstances occur. The put option will expire in 2014. Since the occurrence of the sale is not solely within the control of Changyou, we classify the noncontrolling interest as mezzanine equity instead of permanent equity in our and Changyou's consolidated financial statements.

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

On June 21, 2012, 7Road's Chief Executive Officer surrendered to 7Road, without consideration, ordinary shares of 7Road representing 5.1% of the outstanding ordinary shares of 7Road, in order to increase the availability of ordinary shares available for issuance as equity incentives to employees, directors and consultants of 7Road without dilution of the other shareholders of 7Road. As a result, the noncontrolling interest decreased to 28.074% of 7Road and Changyou's interest in 7Road increased to 71.926%.

Under *ASC subtopic 480-10*, changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. The variance of \$6.8 million caused by 7Road's Chief Executive Officer's surrender of shares was recorded as a credit to additional paid-in capital.

In the third quarter of 2012, Changyou's management estimated that, based on 7Road's performance in the nine months of 2012, 7Road will likely to exceed the specified performance milestones set forth in the acquisition agreement, and accordingly increased the estimated redemption value of the noncontrolling interests in 7Road. The increase in the redemption value was recognized over the period from the date of the 7Road acquisition to the earliest exercise date of the put right as net income attributable to mezzanine-classified noncontrolling interests.

### **Comprehensive Income**

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

### **Segment Reporting**

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



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

### ***Functional Currency***

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

### ***Foreign Currency Translation***

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

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

## **RESULTS OF OPERATIONS**

### **FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011**

In 2011, we adjusted our business groupings from brand advertising business, online game business, sponsored search business, and wireless and others business to online advertising business (consists of the brand advertising business as well as the search and others business), online game business, wireless business and others business. To conform to current period presentations, the relevant amounts for prior periods have been reclassified.

Commencing January 1, 2012, with the development of our business, we reclassified certain expenses for our Search business and our video division.

### **Change in Presentation to Properly Reflect the Classification of Expenses of Video Business**

Prior to 2012, the video division was a relatively small operation in the Sohu Group. It did not have clearly defined business departments because it was highly dependent on the Sohu Group's resources to sustain its operation. The video division's compensation and benefits expenses were recorded under cost of revenues and were not allocated to individual operating expense categories, in view of the fact that most of the employees in the video division provided services related to the maintenance of content and resources that directly contributed to video-related brand advertising revenues.

Commencing January 1, 2012, as the video division has grown significantly and business departments have been defined through the restructuring process to become more self-sustainable, compensation and benefits expenses have been allocated to the respective business departments to properly reflect the operating results of the video division. The video division's compensation and benefits expenses were classified as cost of revenues, product development, sales and marketing and general and administrative expenses, respectively, based on the nature of the related employees' roles and responsibilities. To conform to current period presentations, the relevant amounts for prior periods have been changed accordingly. The change from cost of revenues to operating expenses was not material to historical periods, and amounted to \$1.4 million and \$2.9 million for the three and the nine months ended September 30, 2011.

### **Reclassification of Expenses of Search and Others Business**

To expand distribution of customers' sponsored links or advertisements, the search and others business acquires traffic from third-party Websites. Most traffic acquisition payments are made to Sogou's Website Alliance members. Payments to Sogou's Website Alliance members are based on a portion of pay-for-click revenues generated from clicks by users of their properties, and are included in cost of revenues. A relatively small portion of traffic acquisition payments to third-party Websites are based on pre-agreed unit prices and the actual traffic volume they direct to our search and others business. Prior to 2012, traffic acquisition payments based on pre-agreed unit price and the actual traffic volume were recorded in sales and marketing expenses.

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Commencing January 1, 2012, in order to enhance comparability with industry peers, all traffic acquisition costs were recorded in cost of revenues. To conform to current period presentations, the relevant amounts for prior periods have been reclassified accordingly. Such reclassifications amounted to \$2.0 million and \$5.9 million for the three and the nine months ended September 30, 2011.

### Revenues

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

Revenues	Three Months Ended September 30,			Nine Months Ended September 30,						
	2012	2011	2012 vs 2011	2012	2011	2012 vs 2011				
Online advertising:										
Brand advertising	\$ 77,874	27%	\$ 76,572	33%	\$ 1,302	\$208,154	27%	\$201,453	33%	\$ 6,701
Search and others	35,284	12%	18,410	8%	16,874	85,684	11%	40,002	7%	45,682
Subtotal of online advertising revenues	113,158	39%	94,982	41%	18,176	293,838	38%	241,455	40%	52,383
Online game	151,093	54%	115,798	50%	35,295	415,711	54%	312,259	52%	103,452
Wireless	14,312	5%	14,210	6%	102	43,261	6%	37,559	6%	5,702
Others	6,815	2%	7,870	3%	(1,055)	14,899	2%	14,661	2%	238
Total revenues	\$285,378	100%	\$232,860	100%	\$52,518	\$767,709	100%	\$605,934	100%	\$161,775

Total revenues were \$285.4 million and \$767.7 million, respectively, for the three and nine months ended September 30, 2012, compared to \$232.9 million and \$605.9 million, respectively, for the corresponding periods in 2011. The increase in total revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$52.5 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$161.8 million. The increases were mainly attributable to increases in online game revenues and search and others revenues.

#### Online Advertising Revenues

Online advertising revenues were \$113.2 million and \$293.8 million, respectively, for the three and nine months ended September 30, 2012, compared to \$95.0 million and \$241.5 million, respectively, for the corresponding periods in 2011. The increase in online advertising revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$18.2 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$52.3 million. The increases were mainly attributable to increases in search and others revenues.

#### Brand Advertising Revenues

Brand advertising revenues were \$77.9 million and \$208.2 million, respectively, for the three and nine months ended September 30, 2012, compared to \$76.6 million and \$201.5 million, respectively, for the corresponding periods in 2011. The increase in brand advertising revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$1.3 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$6.7 million. The increases were mainly attributable to increases in revenues from the sectors of fast-moving consumer goods, online game and transportation.

We expect brand advertising revenues to increase modestly in the fourth quarter of 2012, compared to the third quarter of 2012.

#### Search and Others Revenues

Search and others revenues were \$35.3 million and \$85.7 million, respectively, for the three and nine months ended September 30, 2012, compared to \$18.4 million and \$40.0 million, respectively, for the corresponding periods in 2011. The increase in search and others revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$16.9 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$45.7 million. The increases were mainly due to increased traffic and improved monetization of traffic.

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We expect search and others revenues to increase modestly in the fourth quarter of 2012, compared to the third quarter of 2012.

### **Online Game Revenues**

Online game revenues were \$151.1 million and \$415.7 million, respectively, for the three and nine months ended September 30, 2012, compared to \$115.8 million and \$312.3 million, respectively, for the corresponding periods in 2011. The increase in online game revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$35.3 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$103.4 million.

The increases were mainly due to the ongoing popularity of Changyou's flagship game TLBB, the increase in average revenue per active paying account for Changyou's MMOGs, and the growth of Wartune in China. For the three months ended September 30, 2012, average revenue per active paying account of Changyou's MMOGs in China increased by 46% to RMB319, from RMB218 for the three months ended September 30, 2011.

We expect online game revenues to increase in the fourth quarter of 2012, compared to the third quarter of 2012.

### **Wireless Revenues**

Wireless revenues were \$14.3 million and \$43.3 million, respectively, for the three and nine months ended September 30, 2012, compared to \$14.2 million and \$37.6 million, respectively, for the corresponding periods in 2011. The increase in wireless revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$0.1 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$5.7 million. The latter was mainly due to enhanced product distribution programs.

We expect wireless revenues to decrease slightly for the fourth quarter of 2012, compared to the third quarter of 2012.

### **Others Revenues**

Revenues for other services were \$6.8 million and \$14.9 million, respectively, for the three and nine months ended September 30, 2012, compared to \$7.9 million and \$14.7 million, respectively, for the corresponding periods in 2011. The decrease in other revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$1.1 million. The decrease was mainly due to decreased revenues from sub-licensing of licensed video content and cinema advertisement business.

## **Costs and Expenses**

### **Cost of Revenues**

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

	Three Months Ended September 30,			Nine Months Ended September 30,						
	2012	2011	2012 vs 2011	2012	2011	2012 vs 2011				
Cost of revenues:										
Online advertising:										
Brand advertising	\$37,476	39%	\$30,221	44%	\$ 7,255	\$125,331	45%	\$ 76,942	46%	\$ 48,389
Search and others	19,736	20%	9,478	14%	10,258	49,056	18%	24,365	14%	24,691
Subtotal of cost of online advertising revenues	57,212	59%	39,699	58%	17,513	174,387	63%	101,307	60%	73,080
Online game	21,026	22%	14,578	22%	6,448	55,735	20%	33,496	20%	22,239
Wireless	9,474	10%	8,727	13%	747	28,535	10%	22,728	13%	5,807
Others	9,037	9%	4,469	7%	4,568	17,458	7%	11,359	7%	6,099
Total cost of revenues	<u>\$96,749</u>	100%	<u>\$67,473</u>	100%	<u>\$29,276</u>	<u>\$276,115</u>	100%	<u>\$168,890</u>	100%	<u>\$107,225</u>

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Total cost of revenues was \$96.7 million and \$276.1 million, respectively, for the three and nine months ended September 30, 2012, compared to \$67.5 million and \$168.9 million, respectively, for the corresponding periods in 2011. The increase in cost of revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$29.2 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$107.2 million. The increases were mainly attributable to increases in cost of brand advertising revenues and cost of search and others revenues.

### *Cost of Online Advertising Revenues*

Cost of online advertising revenues was \$57.2 million and \$174.4 million, respectively, for the three and nine months ended September 30, 2012, compared to \$39.7 million and \$101.3 million, respectively, for the corresponding periods in 2011. The increase in cost of online advertising revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$17.5 million, and the increase was mainly attributable to increase in cost of search and others revenues. The increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$73.1 million, and the increase was mainly attributable to increase in cost of brand advertising revenues.

### *Cost of Brand Advertising Revenues*

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

Cost of brand advertising revenues was \$37.5 million and \$125.3 million, respectively, for the three and nine months ended September 30, 2012, compared to \$30.2 million and \$76.9 million, respectively, for the corresponding periods in 2011.

The increase in cost of brand advertising revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$7.3 million. The increase mainly consisted of a 2.2 million increase in amortization of licensed video content, a \$2.0 million increase in bandwidth leasing costs, and a \$1.1 million increase in salary and benefits expenses.

The increase in cost of brand advertising revenues from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$48.4 million. The increase mainly consisted of a \$15.6 million increase in amortization of licensed video content, a \$15.1 million increase in impairment of purchased video content, an \$8.8 million increase in bandwidth leasing costs, and a \$2.8 million increase in salary and benefits expenses.

Our brand advertising gross margin was 52% and 40%, respectively, for the three and nine months ended September 30, 2012, as compared to 61% and 62%, respectively, for the corresponding periods in 2011. The decrease in our brand advertising gross margin for the three months ended September 30, 2012 was mainly due to increase in content and bandwidth costs. The decrease for the nine months ended September 30, 2012 was mainly due to increases in content and bandwidth costs and the impairment of purchased video content.

### *Cost of Search and Others Revenues*

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

Cost of search and others revenues was \$19.7 million and \$49.1 million, respectively, for the three and nine months ended September 30, 2012, compared to \$9.5 million and \$24.4 million, respectively, for the corresponding periods in 2011.

The increase in cost of search and others revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$10.2 million. The increase mainly consisted of a \$7.9 million increase in traffic acquisition costs, a \$1.3 million increase in depreciation expenses, a \$0.6 million increase in salary and benefits expenses and a \$0.4 million increase in bandwidth leasing costs, along with increased traffic volume.

The increase in cost of search and others revenues from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$24.7 million. The increase mainly consisted of an \$18.8 million increase in traffic acquisition costs, a \$3.1 million increase in depreciation expenses, a \$1.5 million increase in salary and benefits expenses and a \$1.2 million increase in bandwidth leasing costs, along with increased traffic volume.

Our search and others gross margin was 44% and 43%, respectively, for the three and nine months ended September 30, 2012, as compared to 49% and 39%, respectively, for the corresponding periods in 2011. The decrease in our search and others gross margin for the three months ended September 30, 2012 was mainly due to higher traffic acquisition costs. The increase for the nine months ended September 30, 2012 was mainly due to higher revenues from online marketing services on Sogou Web Directory.

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### *Cost of Online Game Revenues*

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

Cost of online game revenues was \$21.0 million and \$55.7 million, respectively, for the three and nine months ended September 30, 2012, compared to \$14.6 million and \$33.5 million, respectively, for the corresponding periods in 2011.

The increase in cost of online game revenues from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$6.4 million. The increase mainly consisted of a \$3.0 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, a \$1.7 million increase in depreciation and amortization expenses and a \$0.6 million increase in bandwidth leasing costs.

The increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$22.2 million. The increase mainly consisted of a \$7.4 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, a \$5.9 million increase in depreciation and amortization expenses and a \$4.1 million increase in bandwidth leasing costs.

Our online game gross margin was 86% and 87%, respectively, for the three and nine months ended September 30, 2012, as compared to 87% and 89%, respectively, for the corresponding periods in 2011. The decreases in our online game gross margin were mainly due to an increase in headcount and related salaries and benefits expenses, as well as higher bandwidth and server costs as Changyou operated a larger portfolio of online games.

### *Cost of Wireless Revenues*

Cost of wireless revenues mainly consists of revenue sharing with partners, collection charges and transmission fees paid to China mobile network operators, bandwidth leasing costs and depreciation expenses.

Cost of wireless revenues was \$9.5 million and \$28.5 million, respectively, for the three and nine months ended September 30, 2012, compared to \$8.7 million and \$22.7 million, respectively, for the corresponding periods in 2011. The increase in cost of wireless revenues from the three and nine months ended September 30, 2011 to the three and nine months ended September 30, 2012 was \$0.8 million and \$5.8 million, respectively. The increases were mainly due to increased revenue sharing with partners.

The collection charges and transmission fees vary between China mobile network operators. The collection charges and transmission fees mainly included (i) a gateway fee of \$0.008 to \$0.032 per message in the third quarter of 2012, and \$0.005 to \$0.031 per message, depending on the volume of the monthly total wireless messages, in the third quarter of 2011 and (ii) a collection fee of 15% to 87% of total fees collected by China mobile network operators from mobile phone users (with the residual paid to us) in both the third quarter of 2012 and 2011.

Our wireless gross margin was both 34% for the three and nine months ended September 30, 2012, as compared to 39% for both of the corresponding periods in 2011. The decreases in our wireless gross margin were mainly due to increased revenue sharing with partners.

### *Cost of Revenues for Other Services*

Cost of revenues for other services mainly consists of payments to theatres and film production companies for pre-film screening advertisement slots.

Cost of revenues for other services was \$9.0 million and \$17.5 million, respectively, for the three and nine months ended September 30, 2012, compared to \$4.5 million and \$11.4 million, respectively, for the corresponding periods in 2011. The increase in cost of revenues for other services from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$4.5 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$6.1 million. The increases were mainly due to long-lived assets impairment costs for our cinema advertisement business.

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### **Operating Expenses**

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

	Three Months Ended September 30,				Nine Months Ended September 30,					
	2012	2011	2012 vs 2011		2012	2011	2012 vs 2011			
Operating expenses:										
Product development	\$ 46,994	38%	\$28,943	32%	\$18,051	\$128,927	39%	\$ 78,005	34%	\$ 50,922
Sales and marketing	58,250	47%	47,150	51%	11,100	145,903	43%	112,275	48%	33,628
General and administrative	19,666	15%	15,686	17%	3,980	54,968	17%	41,000	18%	13,968
Impairment of intangible assets via acquisition of businesses	0	0%	0	0%	0	2,906	1%	0	0%	2,906
Total operating expenses	<u>\$124,910</u>	100%	<u>\$91,779</u>	100%	<u>\$33,131</u>	<u>\$332,704</u>	100%	<u>\$231,280</u>	100%	<u>\$101,424</u>

Total operating expenses were \$124.9 million and \$332.7 million, respectively, for the three and nine months ended September 30, 2012, compared to \$91.8 million and \$231.3 million, respectively, for the corresponding periods in 2011. The increase in operating expenses from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$33.1 million, and the increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$101.4 million. The increases were mainly attributable to increases in product development expenses and sales and marketing expenses.

#### *Product Development Expenses*

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

Product development expenses were \$47.0 million and \$128.9 million, respectively, for the three and nine months ended September 30, 2012, compared to \$28.9 million and \$78.0 million, respectively, for the corresponding periods in 2011.

The increase in product development expenses from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$18.1 million. The increase mainly consisted of a \$14.7 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, and a \$1.0 million increase in travel expenses.

The increase in product development expenses from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$50.9 million. The increase mainly consisted of a \$39.6 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, a \$2.4 million increase in travel expenses, and a \$2.2 million increase in professional fees.

#### *Sales and Marketing Expenses*

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

Sales and marketing expenses were \$58.3 million and \$145.9 million, respectively, for the three and nine months ended September 30, 2012, compared to \$47.2 million and \$112.3 million, respectively, for the corresponding periods in 2011.

The increase in sales and marketing expenses from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$11.1 million. The increase mainly consisted of a \$7.9 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, a \$1.4 million increase in travel expenses, and a \$0.6 million increase in advertising and promotional expenditures as a result of increased marketing and promotion activities.

The increase in sales and marketing expenses from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$33.6 million. The increase mainly consisted of an \$18.6 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, a \$7.6 million increase in advertising and promotional expenditures as a result of increased marketing and promotion activities, and a \$3.7 million increase in travel expenses.

#### *General and Administrative Expenses*

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

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General and administrative expenses were \$19.7 million and \$55.0 million, respectively, for the three and nine months ended September 30, 2012, compared to \$15.7 million and \$41.0 million, respectively, for the corresponding periods in 2011.

The increase in general and administrative expenses from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$4.0 million. The increase mainly consisted of a \$1.7 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, a \$1.1 million increase in professional service fees, and a \$1.0 million increase in travel expenses.

The increase in general and administrative expenses from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$14.0 million. The increase mainly consisted of a \$6.0 million increase in salary and benefits expenses, which was mainly attributable to increased headcount, a \$3.6 million increase in bad debt expenses and a \$2.2 million increase in professional service fees.

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

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

Share-based compensation expense was recognized in costs and/or expenses for the three and nine months ended September 30, 2012 and September 30, 2011, respectively, as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Share-based compensation expense				
Cost of revenues	\$ 232	\$ 253	\$ 426	\$ 1,543
Product development expenses	1,316	1,633	4,019	4,826
Sales and marketing expenses	582	874	1,613	2,835
General and administrative expenses	1,713	1,617	4,144	4,857
	<u>\$3,843</u>	<u>\$4,377</u>	<u>\$10,202</u>	<u>\$14,061</u>

Share-based compensation expense recognized for share awards of Sohu, Changyou, Sogou, Sohu Video and 7Road, respectively, was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Share-based compensation expense				
For Sohu share-based awards	\$1,440	\$2,607	\$ 4,621	\$ 8,735
For Changyou share-based awards	750	1,172	2,769	4,210
For Sogou share-based awards	1,653	598	2,812	1,116
For Sohu Video share-based awards	0	—	0	—
For 7Road share-based awards	0	—	0	—
	<u>\$3,843</u>	<u>\$4,377</u>	<u>\$10,202</u>	<u>\$14,061</u>

For Sohu share options, as of September 30, 2012 there was no unrecognized compensation expense because the requisite service periods for the remaining share options had ended by the end of 2009. For Sohu restricted share units, as of September 30, 2012 there was \$4.0 million of related unrecognized compensation expense.

For Changyou share-based awards, as of September 30, 2012, there was \$2.5 million of unrecognized compensation expense.

For Sogou share-based awards, as of September 30, 2012, there was \$1.7 million of unrecognized compensation expense.

For Sohu Video, no share-based compensation expense was recognized for the three and the nine months ended September 30, 2012 with respect to Sohu Video share option grants made during those nine months. This is because, under U.S. GAAP, no grant of options had occurred, as no grant date had been established at this stage.

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For 7Road, no share-based compensation expense was recognized for the three and the nine months ended September 30, 2012, as performance targets had not been met.

### **Operating Profit**

As a result of the foregoing, our operating profit was \$63.7 million and \$158.9 million, respectively, for the three and nine months ended September 30, 2012, compared to \$73.6 million and \$205.8 million, respectively, for the corresponding periods in 2011.

### **Other Income /(expense)**

Other income was a negative \$0.1 million and \$3.3 million, respectively, for the three and nine months ended September 30, 2012, compared to other income of \$3.2 million and \$5.2 million, respectively, for the corresponding periods in 2011. The decreases were mainly due to changes in the fair value of consideration payable to 7Road.

### **Interest Income**

Interest income was \$6.0 million and \$19.7 million, respectively, for the three and nine months ended September 30, 2012, compared to \$4.3 million and \$10.3 million, respectively, for the corresponding periods in 2011. The increases were mainly due to increased cash balance and higher return on cash.

### **Income Tax Expense**

Income tax expense was \$18.7 million and \$55.9 million, respectively, for the three and nine months ended September 30, 2012, compared to \$14.4 million and \$35.7 million, respectively, for the corresponding periods in 2011.

The increase in income tax expense from the three months ended September 30, 2011 to the three months ended September 30, 2012 was \$4.3 million. The increase from the nine months ended September 30, 2011 to the nine months ended September 30, 2012 was \$20.2 million. The increases were mainly due to an increase in withholding tax and net income of Changyou, and an increase in the applicable tax rates for the Sohu Group.

### **Net Income**

For the three and nine months ended September 30, 2012, we had net income of \$51.5 million and \$126.1 million, respectively, compared to \$64.3 million and \$181.1 million, respectively, for the corresponding periods of 2011.

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

Net income attributable to noncontrolling interest was \$21.1 million and \$57.6 million, respectively, for the three and nine months ended September 30, 2012, compared to \$16.4 million and \$43.7 million, respectively, for the corresponding periods in 2011.

The increases in net income attributable to noncontrolling interest were mainly due to increased net income of Changyou.

We expect the noncontrolling interest recognized for Changyou to increase in the fourth quarter of 2012, compared to the third quarter of 2012, due to vesting of share-based awards, as well as an increase in Changyou's net income.

We expect the noncontrolling interest recognized for Sogou to remain at a low level.

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

As a result of the foregoing, we had net income attributable to Sohu of \$25.9 million and \$61.8 million, respectively, for the three and nine months ended September 30, 2012, compared to \$46.8 million and \$135.9 million, respectively, for the corresponding periods in 2011.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our principal sources of liquidity are cash and cash equivalents, short-term investments, investments in debt securities, as well as the cash flows generated from our operations.

As of September 30, 2012, we had cash and cash equivalents, short-term investments and investments in debt securities of approximately \$894.3 million. As of September 30, 2011, we had cash and cash equivalents, short-term investments and investments in debt securities of approximately \$808.4 million. Cash equivalents primarily comprise time deposits.



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In November 2009, we entered into an agreement to purchase a Beijing office building to serve as our headquarters. The purchase price is approximately \$127 million, of which \$107 million had been paid as of September 30, 2012. In December 2011, we also entered into an agreement for technological infrastructure and fitting-out work for this office building. The contractual amount is approximately \$28 million, of which \$16 million had been paid as of September 30, 2012. These \$107 million and \$16 million payments have been recognized as prepaid non-current assets in our consolidated balance sheets. The remaining \$20 million for the office building and \$12 million for the technological infrastructure and fitting-out work will be settled in installments as various stages of the development plan are completed. This office building and related technological infrastructure and fitting-out work are in progress and are expected to be completed in 2013.

In August 2010, Changyou entered into an agreement to purchase a Beijing office building to serve as its headquarters. The purchase price is approximately \$157 million, of which \$125 million had been paid as of September 30, 2012 and was recognized as prepaid non-current assets in our consolidated balance sheets. The remaining \$32 million will be settled by early of 2013, when the office building development is expected to be completed.

In the third quarter of 2012, Changyou drew down offshore bridge loans from banks of \$222 million, which were secured by the equivalent or greater amount of RMB deposits in onshore branches of those banks, totaling RMB1.43 billion (\$226 million).

As of September 30, 2012, the Sohu Group also had commitments for bandwidth purchases in the amount of \$25 million, commitments for video content purchases in the amount of \$19 million, commitments for operating leases in the amount of \$12 million and commitments for other content and service purchases in the amount of \$12 million.

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

### **Cash Generating Ability**

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

Our cash flows were summarized below (in thousands):

	Nine Months Ended September 30,	
	2012	2011
Net cash provided by operating activities	\$ 279,781	\$ 256,491
Net cash used in investing activities	(346,743)	(209,936)
Net cash provided by /(used in) financing activities	110,433	(39,209)
Effect of exchange rate change on cash and cash equivalents	(2,609)	21,688
Net increase in cash and cash equivalents	40,862	29,034
Cash and cash equivalents at beginning of period	732,607	678,389
Cash and cash equivalents at end of period	<u>\$ 773,469</u>	<u>\$ 707,423</u>

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

For the nine months ended September 30, 2012, \$279.8 million net cash provided by operating activities was primarily attributable to our net income of \$126.1 million, adjusted by non-cash items of depreciation and amortization of \$76.7 million, impairment of purchased video content of \$15.1 million, share-based compensation expense of \$10.2 million, impairment of intangible assets of \$7.5 million, other miscellaneous non-cash expenses of \$3.6 million, and an increase in cash from working capital items of \$48.2 million, and adjust out the investment income from investments in debt securities of \$4.1 million and excess tax benefits of \$3.5 million.

For the nine months ended September 30, 2011, \$256.5 million net cash provided by operating activities was primarily attributable to our net income of \$181.1 million, adjusted by non-cash items of depreciation and amortization of \$45.5 million, share-based compensation expense of \$14.1 million, and an increase in cash from working capital items of \$19.4 million, offset by a decrease in cash from change in the fair value of debt securities of \$2.2 million and excess tax benefits of \$1.4 million.

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

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

For the nine months ended September 30, 2012, \$346.7 million net cash used in investing activities was primarily attributable to \$225.8 million restricted time deposits used as collateral for offshore bridge loans from banks, \$94.9 million used in acquiring fixed assets and intangible assets, \$20.3 million used in short-term investments, investment income from investments in debt securities of \$4.1 million described above under the heading “*Net Cash Provided by Operating Activities*”, and \$1.6 million used in business acquisition and other investment activities.

For the nine months ended September 30, 2011, \$209.9 million net cash used in investing activities was primarily attributable to \$130.1 million used in acquiring fixed assets and intangible assets including a \$37 million payment for Sohu’s office building, and \$79.8 million used in business acquisitions and investing activities.

### ***Net Cash Provided by /Used in Financing Activities***

For the nine months ended September 30, 2012, \$110.4 million net cash provided by financing activities was primarily attributable to \$222.4 million of offshore bridge loans from banks, \$3.5 million excess tax benefits described above under the heading “*Net Cash Provided by Operating Activities*,” and \$1.3 million from the exercise of share-based awards in a subsidiary, offset by \$64.6 million used for the portion of the Changyou dividend distributed to noncontrolling interest shareholders, \$25.8 million used for the purchase of Sogou Series A Preferred Shares from Alibaba, \$13.8 million used for the payment of contingent consideration, and \$12.6 million used for the repurchase of our common stock.

For the nine months ended September 30, 2011, \$39.2 million net cash used in financing activities was primarily attributable to \$25.7 million used for the purchase of 750,000 Changyou ADSs, and \$16.6 million used for the repurchase of our common stock, offset by \$1.5 million from the issuance of common stock upon the exercise of share options granted under our stock incentive plan, \$1.4 million excess tax benefits mentioned above under the heading “*Net Cash Provided by Operating Activities*,” and \$0.2 million in proceeds from noncontrolling shareholders.

### **Restrictions on Cash Transfers to Sohu.com Inc.**

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

For Sohu apart from Changyou, although the VIEs generate revenue and cash, due to significant costs involved in these VIEs’ operations, they generally have minimal profit and cash balances, and their operating cash flow was negative for the three and nine months ended September 30, 2012. However, substantially all of Changyou’s operations have conducted through Changyou’s VIEs Gamease, Guanyou Gamespace, Shanghai ICE and Shenzhen 7Road, which have generated all of our online game revenues. Although Changyou’s subsidiaries received a majority of the VIEs’ profits pursuant to the various contractual agreements between the VIEs and the subsidiaries, significant cash balances remained in Changyou’s VIEs as of September 30, 2012.

As Changyou’s VIEs are not owned by Changyou’s subsidiaries, they are not able to make dividend payments to Changyou’s subsidiaries. Instead, each of AmazGame, Gamespace, ICE Information and 7Road Technology, which are Changyou’s subsidiaries in China, has entered into a number of contracts with its corresponding VIE to provide services to such VIE in return for cash payments. In order for us to receive any dividends, loans or advances from Changyou’s PRC subsidiaries, or to distribute any dividends to our shareholders and ADS holders, we will need to rely on these payments made from these VIEs to Changyou’s PRC subsidiaries. Depending on the nature of services provided by Changyou’s PRC subsidiaries to their corresponding VIEs, certain of these payments are subject to PRC taxes, including Business Tax and VAT, which effectively reduce the amount that a PRC subsidiary receives from its corresponding VIE. In addition, the PRC government could impose restrictions on such payments or change the tax rates applicable to such payments.

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

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

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With respect to PRC tax, certain dividends paid by WFOEs to their immediate Hong Kong holding companies that meet tax authorities' requirements would be subject to a withholding tax at the rate of 5%, which would reduce the amount of cash available for distribution to Sohu. Any such dividends paid to Hong Kong holding companies that did not meet the tax authorities' requirements would be subject to a withholding tax at the rate of 10%, which would further reduce the amount of cash available for distribution to Sohu.

With respect to U.S. tax, as Sohu Group has two listed companies, Sohu.com Inc. and Changyou.com Limited, which are regarded as separate legal entities for U.S. tax purposes, certain transactions between these two companies as well as between their subsidiaries and VIEs might expose Sohu.com Inc. to 34% U.S. Corporate Income Tax. In addition, certain transactions of Changyou and its subsidiaries and VIEs (for example, investing in U.S. properties) might also expose Sohu.com Inc. to the risk that these transactions will be treated as taxable for U.S. tax purposes. Moreover, if Changyou pays dividends, Sohu.com Inc., as one of the shareholders of Changyou, might be subject to U.S. tax at 34% for the dividends received or, under certain circumstances, when Sohu sells Changyou ADSs originally held by Sohu at a price higher than its U.S. tax basis, a portion of the proceeds will be subject to U.S. tax at 34%. Furthermore, any dividends or any deemed dividends received by Sohu.com Inc. would be subject to U.S. Tax at 34%.

We do not expect any of such restrictions or taxes to have a material impact on our ability to meet our cash obligations.

### **Dividend Policy**

On August 6, 2012, Changyou declared a special one-time cash dividend of \$1.90 per Class A or Class B ordinary share, or \$3.80 per ADS and a total of \$201 million. On September 21, 2012, Changyou paid out this special cash dividend, of which \$136 million was paid to and received by Sohu. Sohu does not expect to pay any of such dividend to its shareholders in the foreseeable future.

We do not expect Changyou to declare any additional dividends in the foreseeable future. The Sohu Group intends to retain all available funds and any future earnings for use in the operation and expansion of its own business, and does not anticipate paying any cash dividends on Sohu.com Inc.'s common stock or causing Changyou to pay any dividends, on Changyou.com Limited's ordinary shares, including ordinary shares represented by Changyou.com Limited's ADSs, for the foreseeable future.

Future cash dividends distributed by Sohu.com Inc. and Changyou.com Limited, if any, will be declared at the discretion of their respective Boards of Directors and will depend upon their future operations and earnings, capital requirements and surplus, general financial condition, contractual restrictions and such other factors as their respective Boards of Directors may deem relevant.

Holders of ADSs of Changyou.com Limited will be entitled to receive dividends, subject to the terms of the deposit agreement, to the same extent as the holders of Changyou.com Limited's ordinary shares, less the fees and expenses payable under the deposit agreement. Cash dividends will be paid by the depository to holders of ADSs in U.S. dollars, subject to the terms of the deposit agreement. Other distributions, if any, will be paid by the depository to holders of ADSs in any manner that the depository deems equitable and practicable.

### **OFF-BALANCE SHEET COMMITMENTS AND ARRANGEMENTS**

We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholder's equity, or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or that engages in leasing, hedging or product development services with us.

## **IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS**

In July 2012, the FASB issued revised guidance on “Testing Indefinite-Lived Intangible Assets for Impairment.” The revised guidance applies to all entities, both public and nonpublic, that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. Under the revised guidance, an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform a quantitative impairment test by comparing the fair value with the carrying amount in accordance with Subtopic 350-30. An entity also has the option to bypass a qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. In conducting a qualitative assessment, an entity should consider the extent to which relevant events and circumstances, both individually and in the aggregate, could have affected the significant inputs used to determine the fair value of the indefinite-lived intangible asset since the last assessment. An entity also should consider whether there have been changes to the carrying amount of the indefinite-lived intangible asset when evaluating whether it is more likely than not that the indefinite-lived intangible asset is impaired. An entity should consider positive and mitigating events and circumstances that could affect its determination of whether it is more likely than not that the indefinite-lived intangible asset is impaired. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity’s financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. We are currently evaluating the impact on our consolidated financial statements of adopting this guidance.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

### **FOREIGN CURRENCY EXCHANGE RATE RISK**

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

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

On June 19, 2010, the People’s Bank of China announced that it has decided to proceed further with the reform of the RMB exchange rate regime to enhance the flexibility of the RMB exchange rate and that emphasis would be placed on reflecting market supply and demand with reference to a basket of currencies. While so indicating its intention to make the RMB’s exchange rate more flexible, the People’s Bank of China ruled out any sharp fluctuations in the currency or a one-off adjustment. As a result of the announcement, the RMB has appreciated significantly. In early November 2012, the center point of the currency’s official trading band hit 6.3017, representing appreciation of more than 7.9%. In the long term, the RMB may appreciate or depreciate more significantly in value against the U.S. dollar or other foreign currencies, depending on the market supply and demand with reference to a basket of currencies.

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

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The following table sets forth a summary of our foreign currency sensitive financial instruments as of September 30, 2012, which consisted of cash and cash equivalents, restricted time deposits, short-term investments, investments in debt securities, accounts receivable, prepaid and other current assets, current liabilities, long-term accounts payable and long-term bank loans. The book value of those financial instruments approximated their fair value.

	Denominated in (in thousands)				Total
	US\$	RMB	HK\$	Others	
Cash and cash equivalents	220,500	552,105	18	846	773,469
Restricted time deposits	0	115,124	0	0	115,124
Short-term investments	0	41,930	0	0	41,930
Investments in debt securities	0	78,852	0	0	78,852
Accounts Receivable	1,001	96,745	0	344	98,090
Prepaid and other current assets	7,825	36,535	0	609	44,969
Current liabilities	141,525	368,666	0	439	510,630
Long-term accounts payable	0	15,042	0	0	15,042
Long-term bank loans	10,000	99,353	0	0	109,353

### INTEREST RATE RISK

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

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

### INFLATION RATE RISK

According to the National Bureau of Statistics of China, the consumer price index grew 2.8% in the first nine months of 2012. While this rate of inflation represents a decline compared to the rate for the previous quarter, there may be further increased inflation in the future, which could have a material adverse effect on our business.

### ITEM 4. CONTROLS AND PROCEDURES

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

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

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

There have been no material developments in the legal proceedings reported in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the SEC on February 28, 2012.

### ITEM 1A. RISK FACTORS

There are no material changes or updates to the risk factors previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the SEC on February 28, 2012; Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2012 filed with the SEC on May 9, 2012; and Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2012 filed with the SEC on August 8, 2012.

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

*Use of Proceeds*

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

During the three months ended September 30, 2012, Sohu did not use any proceeds from the offering. The remaining net proceeds from the offering have been invested in cash and cash equivalents. The use of the proceeds from the offering does not represent a material change in the use of proceeds described in the prospectus contained in the Registration Statement on Form S-1 described above.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

Please see the Exhibit Index attached hereto.

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**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 8, 2012

**SOHU.COM INC.**

By: /s/ Carol Yu

Carol Yu

Co-President and Chief Financial Officer

Sohu.com Inc.

Quarterly Report on Form 10-Q for Quarter Ended September 30, 2012

**EXHIBITS INDEX**

10.1	2012 Share Incentive Plan of 7Road.com Limited
10.2	Loan Facility Letter, dated July 4, 2012, between Hang Seng Bank Limited and Changyou.com HK Limited
10.3	Loan Facility Letter, dated July 12, 2012, between the Bank of East Asia, Limited and Changyou.com HK Limited
10.4	Loan Facility Letter, dated August 7, 2012, between the Bank of Communications Co., Ltd. Hong Kong Branch and Changyou.com HK Limited
31.1	Rule 13a-14(a)/15d-14(a) Certification of Charles Zhang
31.2	Rule 13a-14(a)/15d-14(a) Certification of Carol Yu
32.1	Section 1350 Certification of Charles Zhang
32.2	Section 1350 Certification of Carol Yu
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Condensed Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011; (ii) Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2012 and 2011; (iii) Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2012 and 2011; (iv) Condensed Consolidated Statements of Changes in Equity for the Nine Months Ended September 30, 2012 and 2011; and (v) Notes to Condensed Consolidated Financial Statements, tagged using four different levels of detail.



## 7ROAD.COM LIMITED

## 2012 SHARE INCENTIVE PLAN

**1. Purposes of this Plan**

This 2012 Share Incentive Plan (this “Plan”) is intended to provide incentives: (a) to the directors, officers, employees, consultants and advisors of 7Road.com Limited, a Cayman Islands corporation (the “Company”), and any present or future parents or subsidiaries or variable interest entities (“VIEs”) of the Company by providing them with opportunities to (i) acquire Class A Ordinary Shares of the Company pursuant to options (“Options”) granted hereunder, (ii) to receive Restricted Share Unit awards (“RSU”), and (iii) to make direct purchases of Class A Ordinary Shares of the Company, subject to vesting (“Restricted Shares”). In addition to Options, RSUs, and Restricted Shares, other Awards involving Class A Ordinary Shares and other Awards that are valued in whole or in part by reference to, or are otherwise based upon or settled in, Class A Ordinary Shares, including (without limitation) unrestricted Shares, performance units, dividend equivalents, and convertible debentures, may be granted or sold under this Plan.

**2. Definitions**

“Applicable Laws” means laws of the Company’s jurisdictions of incorporation and operation and requirements relating to the granting or sale of equity incentives and the administration of equity share incentive plans under the laws of any country or other jurisdiction where Awards are issued or sold under this Plan, and under the rules of any securities exchange on which the Class A Ordinary Shares are listed.

“Award” means an Option, RSU, Restricted Share, or other share-based award or right granted or sold pursuant to the terms of this Plan.

“Award Agreement” means a written or electronic document or agreement setting forth the terms and conditions of a specific Award.

“Board” means the Board of Directors of the Company.

“Class A Ordinary Share” means a Class A Ordinary Share in the capital of the Company, having the rights, restrictions, privileges and preferences set forth in the Memorandum and Articles of Association of the Company.

“Compensation Committee” means the full Board or a Compensation Committee appointed by the Board, which Compensation Committee will be constituted to comply with Applicable Laws and which will administer this Plan in accordance with Section 4 below.

“Company” means 7Road.com Limited, a company incorporated under the laws of the Cayman Islands.

“Consultant” means any person who is engaged by the Company or any Parent or Subsidiary or VIE to render consulting or advisory services to such entity, but is not an employee of the Company or any Parent or Subsidiary or VIE.

“Director” means a member of the Board.

“Disability” means any total and permanent disability which prevents a Service Provider from continuing in such capacity.

“Employee” means any person employed by the Company or any Parent or Subsidiary or VIE of the Company. A person will not cease to be an Employee solely by virtue of also being a Director of the Company. A Service Provider will not cease to be an Employee in the case of:

- (i) any leave of absence approved by the Company; or
- (ii) transfers between locations of the Company or between the Company, any Parent, any Subsidiary, any VIE, or any successor to the Company or any Parent, Subsidiary, or VIE.

“Exchange” means NASDAQ, the New York Stock Exchange or any other internationally recognized stock exchange of similar prestige and liquidity.

“Exchange Act” means the U.S. Securities Exchange Act of 1934, as amended and in effect on any given date.

“Fair Market Value” as of any given date means, unless otherwise defined in an Award Agreement, if the Class A Ordinary Shares are listed on an Exchange, the closing price for the Class A Ordinary Shares on such exchange, or if Shares were not traded on such exchange on such given date, then on the next preceding date on which Shares were traded, all as reported in The Wall Street Journal or such other resource as the Compensation Committee deems reliable. If the Class A Ordinary Shares are listed on an Exchange, in the event that an Award is granted on any given date prior to the time that trading has ended on the applicable exchange on such date, Fair Market Value may be determined as of the date preceding such grant. If the Class A Ordinary Shares are not listed on an Exchange, Fair Market Value shall be determined by the Compensation Committee in its good faith discretion, using such methods of appraisal and valuation as it deems appropriate.

“Holder” means the holder of an outstanding Award granted or issued under this Plan.

“Memorandum and Articles of Association” means the Second Amended and Restated Memorandum and Articles of Association of the Company, as amended and effective from time to time.

“Option” means an option granted pursuant to this Plan to purchase Class A Ordinary Shares of the Company.

“Outside Director” means a member of the Board who is not an Employee or Consultant.

“Parent” means any entity which holds directly or indirectly more than fifty percent of the voting equity of the Company.

“Plan” means this 2012 Share Incentive Plan, as amended from time to time.

“Restricted Share” means a Class A Ordinary Share issued subject to forfeiture or repurchase by the Company until vested.

“Restricted Share Unit” or “RSU” means a grant of a hypothetical number of Class A Ordinary Shares, to be settled upon vesting in either Class A Ordinary Shares or cash, as determined by the Compensation Committee.

“Service Provider” means an Employee, Director, or Consultant.

“Share” means a Class A Ordinary Share.

“Subsidiary” means any entity in which the Company holds directly or indirectly more than fifty percent of the voting equity.

“Tax Law” means the relevant tax legislation of an applicable jurisdiction, as amended from time to time and in effect on any given date.

“Underlying Shares” means the Class A Ordinary Shares subject to Options or issuable upon vesting and settlement of RSUs.

“U.S. GAAP” means generally accepted accounting principles in the United States as in effect from time to time.

“U.S. Incentive Stock Options” means Options intended to qualify as incentive stock options within the meaning of Section 422 of the U.S. Internal Revenue Code.

“U.S. Internal Revenue Code” means the U.S. Internal Revenue Code of 1986, as amended from time to time and in effect on any given date.

“U.S. Non-Qualified Stock Option” means an Option not intended to qualify as a U.S. Incentive Stock Option.

“VIE” of the Company means any entity that controls, is controlled by, or is under common control with the Company and is deemed to be a variable interest entity consolidated with the Company for purposes of U.S. GAAP. As used herein, “control” means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of such entity, whether through ownership of voting securities or other interests, by contract or otherwise.

Except where otherwise indicated by the context, the masculine gender will include the feminine gender, and the definition of any term herein in the singular also will include the plural.

### **3. Shares Subject to this Plan**

#### **(a) *Number of Shares Available***

Subject to the provisions of Section 10 of this Plan, the maximum aggregate number of Shares which may be subject to Awards granted and sold under this Plan is 5,100,000 Class A Ordinary Shares. At all times during the term of this Plan and while any Awards are outstanding, the Company will retain as authorized and unissued Class A Ordinary Shares, or as treasury shares, at least the number of Shares from time to time required under the provisions of this Plan, or otherwise assure itself of its ability to perform its obligations hereunder.

#### **(b) *Treatment of Expired, Unvested Shares***

If an Award expires or terminates for any reason or becomes unexercisable without having been exercised or settled in full, the unissued Shares which were subject thereto will become available for future grant, issuance or sale under this Plan. Shares that have actually been issued under this Plan will not be returned to this Plan and will not become available for future distribution under this Plan, except that if Restricted Shares are repurchased by the Company at their original purchase price and cancelled, such Shares will become available for future grant or issuance under this Plan.

**4. Administration of this Plan**

**(a) Compensation Committee**

This Plan will be administered by the Compensation Committee. If the Company has any class of equity security registered under Section 12 of the Exchange Act, and the Company is not a “foreign private issuer” as that term is defined in Rule 3b-4 under the Exchange Act, with the result that the Company’s executive officers and directors become subject to Section 16 of the Exchange Act, this Plan generally will be administered so as to cause transactions in securities issued or to be issued under this Plan to be afforded the exemptions from Section 16(b) of the Exchange Act provided by Rule 16b-3 under the Exchange Act or any similar successor statute or rules.

**(b) Powers of the Compensation Committee**

Subject to the provisions of this Plan and, in the case of the Compensation Committee, the specific duties delegated by the Board to the Compensation Committee, and subject to the approval of any relevant authorities, the Compensation Committee will have the authority in its discretion:

- (i) to determine the Fair Market Value;
- (ii) to select the Service Providers to whom Awards may from time to time be made;
- (iii) to determine the number of Shares or RSUs to be covered by each Award granted;
- (iv) to approve forms of Award Agreement;
- (v) to determine the terms and conditions of any Award. Such terms and conditions include, but are not limited to, the exercise price, the time or times when Options may be exercised, RSUs may be vested or Restricted Shares may no longer be subject to the repurchase right of the Company, or Options, RSUs or Restricted Shares may be forfeited (which in each case may be based on performance criteria), any vesting acceleration or waiver of restrictions, and any restriction or limitation regarding any Award or Class A Ordinary Shares relating thereto, based in each case on such factors as the Compensation Committee may determine; provided, that in no event may any Option or comparable Award granted under this Plan be amended, other than pursuant to Section 10, to decrease the exercise price thereof or otherwise be subject to any action that would be treated, for accounting purposes, as a “repricing” of such Option, unless such amendment or action is approved by the Company’s shareholders;
- (vi) to determine whether and under what circumstances an RSU may be settled in cash instead of Class A Ordinary Shares;
- (vii) to prescribe and amend provisions relating to this Plan, including provisions relating to sub-plans established for the purpose of qualifying for preferred tax treatment under applicable Tax Law;

(viii) to allow holders of Options or other Awards to satisfy withholding tax obligations by electing to have the Company withhold from the Shares to be issued upon exercise of an Option or other Award that number of Shares having a Fair Market Value equal to the amount required to be withheld. The Fair Market Value of the Shares to be withheld will be determined on the date that the amount of tax to be withheld is to be determined. All elections by Holders to have Shares withheld for this purpose will be made in such form and under such conditions as the Compensation Committee may deem necessary or advisable; and

(ix) to construe and interpret the terms of this Plan and Awards granted pursuant to this Plan.

(c) ***Effect of Compensation Committee's Decisions***

All decisions, determinations and interpretations of the Compensation Committee under this Plan will be final and binding on all recipients and, if applicable, transferees of Awards under this Plan.

5. **Eligibility**

(a) ***Service Providers***

Awards may be granted to Service Providers; provided, however, that U.S. Incentive Stock Options may be granted only to Employees of the Company, a Parent, a Subsidiary or a VIE and generally will be granted only to persons who are, or are expected to be, subject to tax on income under the U.S. Internal Revenue Code.

(b) ***No Right to Continued Employment***

Neither this Plan nor any Award will confer upon any recipient or other holder of an Award any right with respect to continuing such recipient's or holder's relationship as a Service Provider with the Company, nor will it interfere in any way with his or her right or the Company's right to terminate such relationship at any time, with or without cause.

6. **Term of Options and RSUs**

The term of each Option or RSU will be stated in the Award Agreement. Notwithstanding the foregoing, with respect to U.S. Incentive Stock Options the term will be no more than ten (10) years from the date of grant thereof and with respect to U.S. Incentive Stock Options granted to a Holder who, at the time the Option is granted, owns shares representing more than ten percent of the voting power of all classes of shares of the Company or any Parent or Subsidiary or VIE, the term of such U.S. Incentive Stock Option will be five (5) years from the date of grant thereof or such shorter term as may be provided in the Award Agreement.

7. **Option Exercise Price, Restricted Share Purchase Price, and Form of Consideration**

(a) ***Exercise Price of Options and Purchase Price of Restricted Shares***

The exercise price for Shares to be issued upon exercise of an Option and the purchase price of Restricted Shares will be such price as is determined by the Compensation Committee, provided that with respect to a U.S. Incentive Stock Option, the exercise price for Shares to be issued upon exercise of such option will not be less than the Fair Market Value on the date of grant. With respect to a U.S. Incentive Stock Option granted to a person who, at the time the U.S. Incentive Stock Option is granted, owns shares representing more than ten percent of the voting power of all classes of shares of the Company or any Parent or Subsidiary, the per Share exercise price will not be less than one hundred ten percent (110%) of the Fair Market Value per Share on the date of grant.

(b) **Form of Consideration**

The consideration to be paid for Shares to be issued upon exercise of an Option and for Restricted Shares, including the method of payment, will be determined by the Compensation Committee. Such consideration may consist of:

- (i) cash,
- (ii) check payable to the order of the Company,
- (iii) promissory note; provided, however, that consideration in the form of a promissory note will not be acceptable if it would constitute a personal loan to an executive officer or director of the Company prohibited by Section 402 of the U.S. Sarbanes-Oxley Act of 2002,
- (iv) other Shares which (x) have been owned by the grantee for more than six (6) months on the date of surrender, and (y) have a Fair Market Value on the date of surrender equal to the aggregate exercise price of the Shares as to which such Option is exercised or the aggregate purchase price of Restricted Shares being purchased,
- (v) consideration received by the Company for the exercise of Options under a cashless exercise program implemented or approved by the Company in connection with this Plan, or
- (vi) any combination of the foregoing methods of payment.

In making its determination as to the type of consideration to accept, the Compensation Committee will consider if acceptance of such consideration may be reasonably expected to benefit the Company.

**8. Vesting of Awards**

(a) **Vesting Generally**

Any Options granted hereunder will become vested and exercisable, any RSUs granted hereunder will vest and be settled, and any Restricted Shares issued hereunder will vest and no longer be subject to forfeiture, according to the terms hereof at such times and under such conditions as determined by the Compensation Committee and set forth in the Award Agreement. Except in the case of Award granted to Outside Directors and Consultants, unless the Compensation Committee determines otherwise as set forth in the Award Agreement, Options will vest and become exercisable, RSUs will vest and be settled, and Restricted Shares will vest and no longer be subject to forfeiture, in four equal annual installments beginning on the first anniversary of the date of grant or issuance of the Award or of such other vesting commencement date prior to the date of grant or issuance of the Award as specified by the Compensation Committee in its sole discretion; provided, that, unless otherwise determined by the Compensation Committee and set forth in the Award Agreement, no Award will vest until the Company's completion of a firm commitment underwritten initial public offering of its shares resulting in a listing on an Exchange and the expiration of all underwriters' lockup periods applicable to such initial public offering. If following the completion of such initial public offering and expiration of such lockup periods, the holder of the Award continues to meet the other requirements, such as continued employment with the Company, for eligibility for vesting, prior vesting thresholds will be deemed to have been met upon such completion and expiration as if such initial public offering had occurred and such lockup periods had expired prior to the making of the Award.

**(b) Settlement of RSUs**

RSUs that will be settled upon vesting, subject to the terms of the Award Agreement, either by delivery to the holder of the number of Shares that equals the number of RSUs that then become vested or by the payment to the holder of cash equal to the then Fair Market Value of that number of Shares. It is contemplated that in most cases the Award Agreement will specify that settlement will be made in Shares rather than in cash.

**(c) Exercise of Options**

An Option will be deemed exercised when the Company receives:

- (i) written or electronic notice of exercise (in accordance with the Award Agreement) from the person entitled to exercise the Option, and
- (ii) full payment for the Shares with respect to which the Option is exercised.

Full payment may consist of any consideration and method of payment authorized by the Compensation Committee and permitted by the Award Agreement and this Plan. Shares issued upon exercise of an Option will be issued in the name of the Holder or, if requested by the Holder, in the name of the Holder and his or her spouse. Until the Shares are issued (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company), no right to vote or receive dividends or any other rights as a shareholder will exist with respect to the Shares, notwithstanding the exercise of the Option. The Company will issue (or cause to be issued) such Shares promptly after the Option is exercised. No adjustment will be made for a dividend or other right for which the record date is prior to the date the Shares are issued, except as provided in Section 10 below.

Exercise of an Option in any manner will result in a decrease in the number of Shares thereafter available, both for purposes of this Plan and for sale under the Option, by the number of Shares as to which the Option is exercised.

To the extent the aggregate Fair Market Value of Shares subject to U.S. Incentive Stock Options which become exercisable for the first time by a Holder during any calendar year (under all plans of the Company or any Parent or Subsidiary or VIE) exceeds \$100,000, such excess Options, to the extent of the Shares covered thereby in excess of the foregoing limitation, will be treated as U.S. Non-Qualified Stock Options. For this purpose, U.S. Incentive Stock Options will be taken into account in the order in which they were granted, and the Fair Market Value of the Shares will be determined as of the grant date of the relevant Option.

**(d) Termination of Relationship as Service Provider of Holder of Options**

If a Holder of Options ceases to be a Service Provider, such Holder may exercise his or her Options within such period of time as is specified in the Award Agreement to the extent that the Options are vested on the date of termination (but in no event later than the expiration of the term of the Options as set forth in the Award Agreement). In the absence of a specified time in the Award Agreement, (i) in the case of U.S. Incentive Stock Options that are so vested, such U.S. Incentive Stock Options will remain exercisable for three (3) months following the Holder's termination, or (ii) in the case of U.S. Non-Qualified Stock Options that are so vested, such U.S. Non-Qualified Stock Options will remain exercisable until the expiration of the term of such U.S. Non-Qualified Stock Options as set forth in the Award Agreement. If, on the date of termination, the Holder is not vested as to his or her entire Option, the Shares covered by the unvested portion of the Options will revert to this Plan. If, after termination, the Holder does not exercise his or her Options within the time specified in the Award Agreement or in this Section 8(d), as the case may be, the Options will terminate, and the Shares covered by such Options will revert to this Plan.

**(e) Disability of Holder of Options**

If a Holder of Options ceases to be a Service Provider as a result of the Holder's Disability, the Holder may exercise his or her Options within such period of time as is specified in the Award Agreement to the extent the Options are vested on the date of termination (but in no event later than the expiration of the term of such Options as set forth in the Award Agreement). In the absence of a specified time in the Award Agreement, (i) in the case of U.S. Incentive Stock Options that are so vested, such U.S. Incentive Stock Options will remain exercisable for twelve (12) months following the Holder's termination, or (ii) in the case of U.S. Non-Qualified Stock Options that are so vested, such U.S. Non-Qualified Stock Options will remain exercisable until the expiration of the term of such U.S. Non-Qualified Stock Options as set forth in the Award Agreement.

If the Disability is not a "disability" as such term is defined in Section 22(e)(3) of the U.S. Internal Revenue Code, in the case of U.S. Incentive Stock Options, such U.S. Incentive Stock Options will automatically convert to U.S. Non-Qualified Stock Options on the day three (3) months and one day following the date such Holder ceased to be a Service Provider as a result of the Holder's Disability. If, on the date of termination, the Holder is not vested as to all of his Options, the Shares covered by the unvested Options will revert to this Plan. If, after termination, the Holder does not exercise his or her Options within the time specified in the Award Agreement or in this Section 8(e), as the case may be, the Options will terminate, and the Shares covered by such Options will revert to this Plan.

**(f) Death of Holder of Options**

If a Holder of Options dies while a Service Provider, the Options may be exercised within such period of time as is specified in the Award Agreement to the extent that the Options are vested on the date of death (but in no event later than the expiration of the term of such Options as set forth in the Award Agreement) by the Holder's estate or by a person who acquires the right to exercise the Options by bequest or inheritance. In the absence of a specified time in the Award Agreement, (i) in the case of U.S. Incentive Stock Options that are so vested, such U.S. Incentive Stock Options will remain exercisable for twelve (12) months following the Holder's termination, or (ii) in the case of U.S. Non-Qualified Stock Options that are so vested, such U.S. Non-Qualified Stock Options will remain exercisable until the expiration of the term of such U.S. Non-Qualified Stock Options as set forth in the Award Agreement. If, at the time of death, the Holder is not vested as to all of his or her Options, the Shares covered by the unvested Options will immediately revert to this Plan. If the Options are not so exercised within the time specified in the Award Agreement or in this Section 8(f), as the case may be, the Options will terminate, and the Shares covered by such Options will revert to this Plan.

**(g) Buyout Provisions**

The Compensation Committee may at any time offer to buy out an Award previously granted for a payment in cash or Shares, based on such terms and conditions as the Compensation Committee may establish, provided that the Company, without the approval of the Company's stockholders, may not buy out any outstanding Option where such buy out would be treated as a "repricing" for accounting purposes.



## **9. Awards**

### **(a) *Rights to Receive or Purchase***

Awards may be issued either alone, in addition to, or in tandem with other Awards granted under this Plan and/or cash awards made outside of this Plan. After the Compensation Committee determines that it will offer Awards under this Plan, it will advise the offeree in writing or electronically of the terms, conditions and restrictions related to the offer, including the number of Shares that such person will be entitled to receive or purchase, the price to be paid, if any, and the time within which such person must accept such offer.

### **(b) *Repurchase Option; Forfeiture of Non-vested Shares***

Unless the Compensation Committee determines otherwise, the Award Agreement will grant the Company a repurchase option exercisable upon the voluntary or involuntary termination of the Holder's service with the Company for any reason (including death or Disability) in the event that the Holder purchased or otherwise received Shares under the Award Agreement and such Shares are non-vested. The purchase price for Shares repurchased pursuant to the Award Agreement will be the original price paid by the Holder and may be paid, at the Compensation Committee's option, by cancellation of any indebtedness of the Holder to the Company. The repurchase option will lapse at such rate as the Compensation Committee may determine. Except with respect to Shares purchased by Outside Directors and Consultants, unless set forth expressly in the Award Agreement, the repurchase option will in no case lapse at a rate of less than twenty-five percent per year over four years from the date of receipt or purchase. Unless the Compensation Committee determines otherwise, the Award Agreement will provide for the forfeiture of the non-vested Shares underlying an Award upon the voluntary or involuntary termination of the Holder's service with the Company for any reason (including death or Disability).

### **(c) *Other Provisions***

The Award Agreement will contain such other terms, provisions and conditions not inconsistent with this Plan as may be determined by the Compensation Committee in its sole discretion.

### **(d) *Rights as a Shareholder***

Once an Award is exercised, the Holder will have rights equivalent to those of a shareholder and will be a shareholder when his or her purchase is entered upon the records of the duly authorized transfer agent of the Company. No adjustment will be made for a dividend or other right for which the record date is prior to the date the Award is exercised, except as provided in Section 10 below.

## **10. Adjustments Upon Changes in Capitalization or Asset Sale**

### **(a) *Changes in Capitalization***

Subject to any required action by the shareholders of the Company, the number of Shares covered by each outstanding Award, and the number of Shares which have been authorized for issuance under this Plan but as to which Awards have yet been granted or which have been returned to this Plan upon cancellation or expiration of an Award, as well as the price per Share covered by each such outstanding Award, will be proportionately adjusted for any increase or decrease in the number of issued Shares resulting from a reclassification of the Shares, or any other increase or decrease in the number of issued Shares effected without receipt of consideration by the Company. The conversion of any convertible securities of the Company will not be deemed to have been "effected without receipt of consideration." Such adjustment will be made by the Compensation Committee, whose determination in that respect will be final and binding. Except as expressly provided herein, no issuance by the Company of equity shares of any class, or securities convertible into equity shares of any class, will affect, and no adjustment by reason thereof will be made with respect to, the number or price of Shares subject to an Award.

**(b) Adjustments for Share Splits and Share Dividends**

If the Company at any time increases or decreases the number of its outstanding Shares, or changes in any way the rights and privileges of such Shares by means of the payment of a share dividend or any other distribution upon such Shares, or through a share split, subdivision, consolidation, combination, reclassification or recapitalization involving the Shares, then in relation to the Shares that are affected by one or more of the above events, the numbers, rights and privileges of the following will be increased, decreased or changed in like manner as if such Shares had been issued and outstanding, fully paid and nonassessable at the time of such occurrence: (i) the number of Shares as to which Awards may be made under this Plan; and (ii) the Shares included in each outstanding Award made hereunder.

**(c) Dissolution or Liquidation**

In the event of the proposed dissolution or liquidation of the Company, the Compensation Committee will notify each Holder as soon as practicable prior to the effective date of such proposed transaction. The Compensation Committee in its discretion may provide for a Holder to have the right to exercise his or her Options until fifteen (15) days prior to such transaction as to all of the Underlying Shares covered thereby, including Shares as to which the Options would not otherwise be exercisable. In addition, the Compensation Committee may provide that any Company repurchase option applicable to any Shares purchased pursuant to an Award will lapse as to all such Shares, provided the proposed dissolution or liquidation takes place at the time and in the manner contemplated. To the extent it has not been previously exercised, an Award will terminate immediately prior to the consummation of such proposed action.

**(d) Consolidation or Asset Sale**

If the Company is to be consolidated with or acquired by another person or entity in a sale of all or substantially all of the Company's assets or equity share capital or otherwise (an "Acquisition"), the committee or the board of directors of any entity assuming the obligations of the Company hereunder (the "Successor Board") may in its sole discretion, take one or more of the following actions with respect to outstanding Options, Shares acquired upon exercise of any Option, outstanding RSUs, or unvested Restricted Shares: (i) make appropriate provision for the continuation of such Awards by substituting on an equitable basis for the Underlying Shares the consideration payable with respect to the outstanding Shares in connection with the Acquisition; (ii) accelerate the date of exercise of such Options, vesting and settlement of RSUs, or vesting of Restricted Shares, or of any installment of any such Options, RSUs or Restricted Shares; (iii) upon written notice to the participants, provide that all Options must be exercised, to the extent then exercisable, within a specified number of days of the date of such notice, at the end of which period the Options, including those which are not then exercisable, shall terminate; (iv) terminate all Options or RSUs in exchange for a cash payment equal to the excess of the fair market value of the shares subject to such Options or RSUs (to the extent then exercisable) over the exercise price thereof (if any); or (v) in the event of a Share sale, require that the participant sell to the purchaser to whom such Shares sale is to be made, all Shares previously issued to such participant upon exercise of any Option, pursuant to any RSU, or as Restricted Shares at a price equal to the portion of the net consideration from such sale which is attributable to such Shares. Nothing contained herein will be deemed to require the Company to take, or refrain from taking, any one or more of the foregoing actions.

(e) ***No Fractional Shares***

If any adjustment or substitution provided for in this Section 10 results in the creation of a fractional Share under any Option, the Company will, in lieu of issuing such fractional Share, pay to the Holder a cash sum in the amount equal to the product of such fraction multiplied by the Fair Market Value of a Share on the date the fractional Share otherwise would have been issued.

(f) ***Determination by the Compensation Committee***

Adjustments under this Section 10 will be made by the Compensation Committee whose determinations with regard thereto will be final and binding upon all parties.

**11. Time of Granting of Award**

The date of grant of an Award will be the date on which the Compensation Committee makes the determination granting such Award, or such other date as is determined by the Compensation Committee; provided that such other date will not be prior to the date of the Compensation Committee's determination to grant such Award; provided, further, that the foregoing will not prohibit the Compensation Committee from determining, in its discretion, to specify a vesting commencement date prior to the date of the grant. Notice of the determination will be given to each Service Provider to whom an Award is so granted within a reasonable time after the date of such grant.

**12. Non-Transferability of Awards**

Awards may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than as provided in the Award Agreement, this Plan, by will or by the laws of succession and may be exercised, during the lifetime of the Holder, only by the Holder.

**13. Conditions Regarding Issuance of Shares**

(a) ***Legal Compliance***

Shares will not be issued pursuant to the exercise of Options, the settlement of RSUs, or the purchase of Restricted Shares unless the issuance and delivery of such Shares will comply with Applicable Laws, and the issuance of Shares will be subject to confirmation from legal counsel for the Company as to such compliance.

(b) ***Investment Representations***

The Compensation Committee may require the person receiving Shares upon exercise of Options, settlement of RSUs, or purchase of Restricted Shares to represent and warrant, as a condition to such receipt, that the Shares are being purchased only for investment and not with a view to the distribution of such Shares.

(c) ***Inability to Obtain Authority***

The inability of the Company to obtain authority from any regulatory body having jurisdiction will relieve the Company of any liability in respect of the failure to issue or sell such Shares as to which such requisite authority has not been obtained.

(d) ***Withholding***

The Company's obligations to deliver Shares upon the exercise of an Award will be subject to the Holder's satisfaction of all applicable Tax Law, including withholding requirements, of all applicable jurisdictions.

**14. Amendment and Termination of this Plan**

(a) ***Amendment and Termination***

The Board may at any time amend, suspend or terminate this Plan.

(b) ***Shareholder Approval***

The Board will obtain shareholder approval of any Plan amendment to the extent necessary or desirable to comply with Applicable Laws.

(c) ***Effect of Amendment or Termination***

Except as may be required by Applicable Law, no amendment, suspension or termination of this Plan will impair the rights of any Holder, unless agreed otherwise in writing between the Holder and the Compensation Committee. Termination of this Plan will not affect the Compensation Committee's ability to exercise the powers granted to it hereunder with respect to Awards granted under this Plan prior to the date of such termination.

**15. Effectiveness and Term of Plan**

This Plan will become effective upon its adoption by the Board and approval by the Company's shareholders. It will continue in effect, with regard to the making of Awards, for a term of ten (10) years unless sooner terminated under Section 14 above and with regard to the terms of an Award Agreement, for such longer term as may be required to give effect to that Award Agreement for a term of ten (10) years unless sooner terminated under Section 14 above.

- Approved and adopted by the Board of Directors on July 10, 2012.
- Approved and adopted by the Company's shareholders on July 10, 2012.



恒生銀行  
HANG SENG BANK

理財創富 專注為你  
Managing wealth for you, with you.

Our Ref: Commercial Banking – A120522, CM120613, 120626 and LN120703

**Confidential**

4 July 2012

Changyou.com Limited  
Changyou.com HK Limited  
East Tower Jing Yan Building  
No.29 Shijingshan Road  
Shijingshan District  
Beijing 100043  
China

Attention: Ms. Jackie Li

Dear Sirs,

**BANKING FACILITIES**

With reference to our recent discussions, we, Hang Seng Bank Limited (the “**Bank**”) are pleased to offer the following banking facility/ facilities (the “**Facilities**”) to the borrower(s) specified below (the “**Borrower**”).

The Facilities will be made available on the terms and conditions set out in this letter and the Standard Terms and Conditions for Banking Facilities attached and upon satisfactory completion of the security specified below.

The Facilities are subject to review at any time and in any event by **30 June 2013** and also subject to our overriding right of repayment on demand, including the right to call for cash cover on demand for prospective and contingent liabilities. The Bank shall have an unrestricted discretion to cancel or suspend, or determine whether or not to permit drawings in relation to, the Facilities.

**1. Borrower**

Changyou.com Limited  
Changyou.com HK Limited

**2. Facilities and Limits**

Term Loan Facility (TL)	USD150,000,000
<b>Total</b>	<b>USD150,000,000</b>

恒生銀行有限公司 Hang Seng Bank Limited  
香港中環德輔道中83號 83 Des Voeux Road Central Hong Kong  
電話 Tel (852) 2198 1111 圖文傳真 Fax (852) 2868 4047  
電傳 Telex 73311 HASEB HX 網址 Website www.hangseng.com



獲頒國際證書 ISO 14001 certified  
全球最被認可之環境管理系統標準  
The world's most recognised standard  
for environmental management systems

Member HSBC Group 滙豐集團成員

3. **Facilities and Conditions**

Term Loan Facility

: Loan Amount: USD150,000,000

Purpose: To finance the Borrower's dividend payment and general working capital.

Final Maturity Date: 1 years from the date of drawdown

Drawdown Availability Period: Within 3 months from the date of this letter.

Drawdown: Drawdown can be made on any Business Day within the availability period by giving the Bank two Business Days prior written notice and the drawdown may be in minimum of USD1,000,000.

Interest Rate and Payment: 2.5% per annum over LIBOR or the Bank's Cost of Funds, whichever is higher, payable at the end of each interest period or quarterly in arrears if 6/12 months period is selected. The Borrower may select an interest period which shall be 1/3/6/12 month(s). No Interest Period shall extend beyond the Final Maturity Date.

Repayment: Principal is repaid in one lump sum on the Final Maturity Date.

All sums which may become due to the Bank from time to time in respect of this facility (including but not limited to principal and interest) are to be directly debited from the account maintained with the Bank.

Prepayment: Prepayment (in whole or in part) is allowed provided that the Bank receives 7 Business Days' prior written notice and such prepayment is made on an interest payment date.

Condition(s):

- (1) Submission of legal opinion on the Borrower / guarantor(s) which incorporated overseas (if any) to the Bank.
- (2) The Borrower shall maintain deposits not less than the outstanding balance of the TL facility or its equivalent in other currencies placed in Beijing Branch of Hang Seng Bank (China) Limited (the "Deposits").
- (3) The Borrower shall ensure that the Deposits in name of 北京畅游天下网络技术有限公司 (i.e. or Beijing AmazGame Age Internet Technology Co. Ltd.).
- (4) The Deposits can be released subject to this facility fully repaid.
- (5) For dividend payment, the proceeds should be remitted to designated bank(s) for dividend payment as proof of the loan purpose. The Borrower shall submit to the Bank the payment evidence of the dividend within 2 months from the drawdown date of this facility.
- (6) For general working capital, the proceeds should be directly remitted to the Borrower's subsidiaries or entities. The Borrower shall submit to the Bank the payment evidence within 2 months from the drawdown date of this facility.
- (7) Only USD30,000,000 loan proceeds of the TL facility can be applied toward general working capital usage, all remaining portion shall be applied for dividend purpose.

4. Security

**The availability of the Facilities is conditional upon the Bank's receipt of the following documents in form and substance satisfactory to the Bank:-**

- (1) A **Cross Guarantee** in the Bank's standard form for USD150,000,000 from the Borrower.

The Borrower and the corporate guarantor(s) (if any) and the corporate security provider(s) (if any) shall provide certified true copies of any consent, license, approval or authorization of, or registration or declaration with any governmental authority, bureau or agency required in connection with the execution, delivery, performance, validity and enforceability of this facility and all other documents required by the Bank.

The Borrower and the corporate guarantor(s) (if any) and the corporate security provider(s) (if any) shall provide such other documents, items or evidence as the Bank may reasonably request from time to time.

**5. Undertakings**

**The Borrower and the under-mentioned undertaking parties (if any) will undertake to the Bank as follows:-**

- (1) Changyou.com Limited shall remain its listing status in NASDAQ and its shares shall not be suspended for trading for more than (10) consecutive trading days, unless getting the Bank's consent.
- (2) Changyou.com HK Limited shall remain 100% directly or indirectly owned by Changyou.com Limited.
- (3) The Borrower shall ensure that the depositors 北京畅游天下网络技术有限公司 (i.e. or Beijing AmazGame Age Internet Technology Co. Ltd.) shall be directly or indirectly owned by Changyou.com HK Limited.
- (4) The Borrower undertakes that for any Facilities denominated in Renminbi (if any), it will not directly or indirectly on-lend the proceeds of such Facilities to (i) any individuals and (ii) any Designated Business Customers if the proceeds of such Facilities (or any other Renminbi proceeds derived therefrom) are directly or indirectly credited to Renminbi accounts for the category of Designated Business Customers which are maintained for limited purposes of handling Renminbi cashnotes obtained in their ordinary course of business as Designated Business Customers and for Renminbi bond investment.

“Designated Business Customers” means establishments that have had a business relationship with a Hong Kong Renminbi business participating bank for more than three years which engage in commercial retail, catering, accommodation, transportation services, communications services, medical services, or educational services, including such establishments that have had a business relationship with such participating bank for less than three years, but with concrete evidence to show that they have the actual relevant business background.

The Borrower shall and agree to indemnify the Bank for all losses and liabilities incurred or suffered by the Bank arising out of or in connection with any breach of the above undertaking by the Borrower.

- (5) The Borrower and the corporate guarantor(s) (if any) shall provide to the Bank a certified copy of its annual audited accounts/financial statements within 180 days after the end of each financial year and such other relevant financial information as the Bank may from time to time reasonably request.



- (6) Each of the Borrower and the corporate guarantor(s) (if any) and the corporate security provider(s) (if any) shall immediately inform the Bank once there are changes of its directors or beneficial shareholders or amendment to its memorandum and articles of association or equivalent constitutional documents and shall ensure that such changes/amendment are updated in the company registry of its place of incorporation promptly.

**6. Fees**

Upon completing each review of the Facilities, the Bank is authorised to debit the current account maintained by the Borrower with the Bank for the facility review fee as the Bank may prescribe from time to time.

**Section 83 of the Banking Ordinance**

Section 83 of the Banking Ordinance (Cap. 155, Laws of Hong Kong) has imposed on us as a bank certain limitations on advances to persons related to our directors or employees. In accepting the Facilities, the Borrower should advise us whether the Borrower is in any way related to any of our directors or employees within the meaning of Section 83 and in the absence of such advice we will assume that the Borrower is not so related. We would also ask that if the Borrower becomes so related subsequent to accepting the Facilities, the Borrower should immediately advise us in writing.

Please note that in reviewing the application, we may make reference to the credit report(s) of the Borrower(s)/guarantor(s)/security provider(s) (as the case may be) from the credit reference agency(ies). If you wish to access the report(s) yourself, you can contact the credit reference agency(ies) directly at the following address:

Commercial credit reference agency:

Dun & Bradstreet (HK) Ltd., Unit 1308-1315, 13/F., BEA Tower, Millennium City 5, 418 Kwun Tong Road, Kwun Tong, Kowloon.

Tel: 2516 1100 ; Fax: 2960 4721.

Please arrange for the enclosed copy of this letter to be signed by the Borrower and all guarantors and security providers of the Facilities and return the same to the Bank with Board Resolution(s) and Shareholder's Resolution(s) (if applicable) of the Borrower and all guarantors and security providers before **13 August 2012**, failing which our offer shall lapse unless it is extended by us at our absolute discretion.

By accepting this Facility Letter, you would agree to channel all your remittance transactions and insurance arrangement to the Bank. Our Cash Management & Payment Services Department and Commercial Sales Department would contact you to offer our services on remittance and insurance respectively.

**Changyou.com Limited**

**Our Ref: Commercial Banking – A120522, CM120613, 120626 and LN120703**

Should you have any queries, please do not hesitate to contact the following persons:-

Queries on	Name	Telephone No.
Banking arrangement	Ms. Chui Sze Ka Bianca	21985223
Factoring arrangement	Ms. Carol Cheng	21988200
Insurance	Mr. Stanley Ng	36625056
	Mr. John Li	21982522
Remittance	Mr. Billy Chow	21984534
	Remittance Hotline	21986919
Wealth management	Ms. Mandy Chan	21985920
Execution of documents	Documentation Hotline	21982094

Kindly return the accepted Facility Letter and executed documents to **Credit Operations Manager, Credit Operations Department, 12/F., 83 Des Voeux Road Central, Hong Kong.**

We trust that you will make active use of the Facilities and are pleased to be of continued assistance.

Yours faithfully,  
For Hang Seng Bank Limited

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Jessica Hung  
Senior Vice President  
Portfolio Management and Compliance  
Corporate and Commercial Banking

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Jones Chung  
Vice President  
Portfolio Management and Compliance  
Corporate and Commercial Banking

VL/wc

I/We hereby accept the Facilities and agree to be bound by all the terms and conditions set out in this letter and the Standard Terms and Conditions for Banking Facilities, which I/we have read and understood.

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Changyou.com Limited

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Changyou.com HK Limited

Our reference number: FL923A\_ Changyou.com \_new

12<sup>th</sup> July, 2012

Confidential

Changyou.com Limited  
East Tower, Jing Yan Building  
No. 29 Shijingshan Road  
Shijingshan District  
Beijing 100043, PRC

Attn: Mr. Alex Ho

Dear Sirs,

Re: Changyou.com Limited  
RMB630 Million Term Loan Facility

This letter (this “Facility Letter”) sets out the terms and conditions upon which The Bank of East Asia, Limited will provide a RMB630 Million term loan facility to Changyou.com Limited.

**(1) Borrower:**

Changyou.com Limited, a company incorporated in Cayman Islands and having its registered office at Offshore Incorporations (Cayman) Limited, Scotia Centre, 4<sup>th</sup> Floor, P.O. Box 2804, George Town, Grand Cayman KY1-1112, Cayman Islands (the “Borrower”).

**(2) Lender:**

The Bank of East Asia, Limited, whose registered office is situated at No. 10 Des Voeux Road Central, Hong Kong (the “Lender”).

**(3) Nature and Facility Amount:**

A term loan facility (the “Facility”) of up to a maximum principal amount of RMB630,000,000.00 (Renminbi Six Hundred Thirty Million Only) (the “Facility Limit”).

**(4) Purpose:**

To finance the dividend distribution, overseas acquisitions and capital injection into overseas subsidiaries of the Borrower.

**(5) Final Maturity Date:**

The final maturity date of each drawing/advance under the Facility (the “Final Maturity Date of each Advance”) shall be (i) the date falling 14 days before the expiry date of the respective Standby L/C (as hereinafter defined in Paragraph (14) below) supporting such drawing/advance or (ii) the date falling 24 months from the date of the Lender’s receipt of the Borrower’s acceptance of this Facility Letter (the “Acceptance Date”), whichever is earlier.

**(6) Drawing/Availability:**

The Facility is available for multiple drawings on any Business Day within 3 months (the “Availability Period”) from the Acceptance Date provided that:-

- (a) The Lender shall have received in form and substance satisfactory to it all of the documents and other evidence as listed in the “Conditions Precedent” as stipulated in Paragraph (7) hereof;
- (b) Each drawing shall be in a minimum amount of RMB200 Million and if for a larger amount, an integral multiple of RMB10 Million;
- (c) The total loan(s) outstanding after taking into account of the amount of the proposed drawing(s) shall not exceed the Facility Limit;
- (d) Each drawing shall have been supported by the respective Standby L/C issued by the Issuing Bank (as hereinafter defined in Paragraph (14) below) in RMB for an amount not less than 100% of the corresponding amount of drawing;
- (e) The Borrower shall have given not less than 3 Business Days’ prior written notice of drawing to the Lender specifying the date and the amount of the proposed drawing;
- (f) The maximum number of drawings shall not exceed 3; and
- (g) Any undrawn balance at the end of the Availability Period will be cancelled automatically.

**(7) Conditions Precedent:**

The obligation of the Lender to make available the Facility to the Borrower hereunder is conditional upon:

- (a) The Borrower having furnished to the Lender, prior to the date of first drawing (the "First Drawdown Date") under the Facility, the following in form and substance satisfactory to the Lender:
  - (i) Certified true copy of the Borrower's Certificate of Incorporation, Certificate of Incorporation on Change of Name (if any), Certificate of Incumbency, Certificate of Good Standing and updated Memorandum and Articles of Association (or applicable constitutional documents);
  - (ii) Certified true copy of the resolutions (with copy list of specimen signature(s) of authorised signatory(ies) enclosed thereon) duly passed at a duly convened and held meeting of the Board of Directors of the Borrower evidencing (i) the approval of the Facility, (ii) the acceptance of the terms and conditions of this Facility Letter and (iii) the authorization of appropriate officer(s) to countersign this Facility Letter and to sign on behalf of the Borrower all confirmations, notice of drawing and other notices, requests or other communications required to be made and given to the Lender hereunder or otherwise in connection with the Facility;
  - (iii) The duplicate of this Facility Letter duly signed by the authorised signatory(ies) of the Borrower;
  - (iv) Copy of Hong Kong Identity Card or passport of each of the officers of the Borrower authorised to sign the documents as referred to in sub-paragraphs (ii) and (iii) hereinabove;
  - (v) Due payment by the Borrower of the Arrangement Fee as referred to in Paragraph (9) below; and
  - (vi) Such other documents as the Lender may request.

- (b) The Lender being satisfied with the corporate power and legal capacity of the Borrower to enter into the document as referred to in sub-paragraph (a)(iii) hereinabove and for this purpose, the Lender may require legal opinions or such other documents relating to any of the matters contemplated herein to be provided in form and substance satisfactory to the Lender at the expense of the Borrower.
- (c) There being no material adverse change in the financial market condition and in the financial condition of the Borrower.

**(8) Interest Rate:**

(a) Normal Interest

Interest on all the loan(s) outstanding of the Facility shall be calculated at the fixed rate of 3.75% per annum. Interest shall be calculated on the basis of the actual number of days elapsed on a 360-day year. Interest accrued shall be payable quarterly in arrears by the Borrower on the last Business Day of each calendar quarter (each an "Interest Payment Date") and on the corresponding Final Maturity Date of each Advance.

(b) Default Interest

In respect of the loan(s) outstanding under the Facility, interest thereon and other sums in respect of the Facility not repaid or paid on the due date or dates provided hereunder, interest shall be payable on demand from the due date or dates for payment thereof until the date of actual payment in full of such loan(s) outstanding and/or interest and/or other sums (as the case may be) at the rate of 5% per annum over the rate of interest as determined by the Lender in accordance with sub-paragraph (a) of this Paragraph (8) (both before and after judgement). For so long as the default continues, the relevant rate of interest shall be re-determined by the Lender on the same basis thereafter and shall be compounded at weekly intervals.

**(9) Arrangement Fee:**

An arrangement fee of RMB100,000.00 (Renminbi One Hundred Thousand Only) (the "Arrangement Fee") shall be payable by the Borrower on the earlier of (i) the date falling 14 Business Days after the Acceptance Date and (ii) the First Drawdown Date and is non-refundable in any event.

**(10) Undrawn Balance Fee:**

Waived.

**(11) Repayment:**

Subject to Paragraph (13) hereinbelow, all outstanding amounts of each drawing/advance of the Facility including but not limited to the principal outstanding, the accrued interest and any other sums owing to the Lender shall be repaid in full on the corresponding Final Maturity Date of each Advance. Amount repaid is not available for re-drawing.

**(12) Voluntary Prepayment:**

The Borrower may on any Interest Payment Date prepay in whole or in part the loan(s) outstanding under the Facility provided that:

- (a) The Borrower shall have given not less than 5 Business Days' prior written notice of prepayment to the Lender, specifying the amount to be prepaid and the date of such prepayment;
- (b) Each partial prepayment shall be in a minimum amount of RMB200 Million and if for a larger amount, an integral multiple of RMB10 Million;
- (c) Each prepayment shall be made together with accrued interest on the amount prepaid and any other amounts (including but not limited to funding loss, if any) payable by the Borrower in respect thereof on the date of prepayment; and
- (d) Amount prepaid is not available for re-drawing.

**(13) Lender's Overriding Rights:**

Notwithstanding anything contained herein to the contrary (in particular, Paragraphs (5) and (11)), the Facility is subject to the Lender's review, amendment of any terms and/or cancellation of all or any part thereof from time to time at the sole discretion of the Lender and the loan(s) outstanding, interest thereon and any other sums owing or payable under the Facility are subject to the Lender's customary overriding right of repayment on demand. The Lender hereby expressly reserves the unfettered right of terminating the Facility and/or requiring repayment of all monies owing from or payable by the Borrower to the Lender at any time by notice in writing to the Borrower, whereupon the Facility or any part thereof as stipulated in the Lender's notice shall forthwith be terminated and/or all monies owing from or payable by the Borrower to the Lender or any part thereof as stipulated in the Lender's notice shall forthwith be repaid by the Borrower.

**(14) Security:**

Standby Letter of Credit(s) (the “Standby L/C”) in form and substance as approved by the Lender for the amount of not less than 100% of the corresponding advance(s)/drawing(s) under the Facility in RMB, to be issued by The Bank of East Asia (China), Limited, Beijing Branch (the “Issuing Bank”) in favour of the Lender as the beneficiary, whereby the Issuing Bank shall honour its payment obligation to the Lender up to the amount as stipulated in the respective Standby L/C upon and subject to the terms and conditions contained therein.

(This Facility Letter and the Standby L/C are collectively referred to as the “Finance Documents”).

**(15) Payments:**

- (a) On the date of each drawing under the Facility, the Lender shall make the advance available to the Borrower by crediting the same in Renminbi in same day funds to the account designated in the notice of drawing given by the Borrower or in such other manner as the Borrower may specify in the irrevocable notice of drawing given by the Borrower (provided that such other manner as specified by the Borrower must be acceptable to the Lender);
- (b) On each date on which any sum is due or payable by the Borrower under or in connection with the Facility, the Borrower shall either (i) make such sum available before 11:00 a.m. (Hong Kong time) in same day funds in its CorporatePlus account maintained with the Lender (Account No.: 015-514-68-00423-4) (the “CorporatePlus Account”), (ii) by CHATS before 11:00 a.m. (Hong Kong time) in same day funds to the Lender’s account no. 015-514 (S.W.I.F.T. BEASHKHH) or (iii) in such other manner as instructed by the Lender. The Borrower hereby irrevocably authorises the Lender to debit the CorporatePlus Account on any date on which any sum is due or payable under or in connection with the Facility without further consent from or notice to the Borrower;
- (c) Whenever any payment under this Facility Letter (including but not limited to the principal repayment and interest payment) or otherwise in connection with the Facility shall become due on a day which is not a Business Day, the due date thereof shall be extended to the next Business Day in the same calendar month (if there is one) or on the preceding Business Day (if there is no succeeding Business Day in the same calendar month); and



- (d) All payments by the Borrower hereunder shall be made free and clear of any deduction or withholding on account of tax, levy, impost, duty or charges of whatsoever nature ("Tax Payment"). The Borrower shall as soon as practicable deliver to the Lender relevant receipts for any Tax Payment required to be made by it. If any withholding or deduction is required, the amount to be paid by the Borrower must be increased to the extent that the Lender will receive such amount as it would otherwise have been entitled to receive had there been no such deduction or withholding.

**(16) Increased Costs:**

If as a result of (i) the introduction of or any change in (or in the interpretation, administration or application of) any law or regulation (which shall include, without limitation, any law or regulation concerning capital adequacy, prudential limits, liquidity, reserve assets or tax); or (ii) compliance with any law, regulation, direction, request or requirement (whether or not having the force of law) of any competent governmental or other authority made after the date of this Facility Letter, any increased costs are incurred or suffered by the Lender, which shall include (1) a reduction in the rate of return from the Facility or on the Lender's overall capital (including, without limitation, as a result of any reduction in the rate of return on capital brought about by more capital being required to be allocated by the Lender); and/or (2) a reduction of any amount due and payable under the Finance Documents ("Increased Costs"), the Borrower shall:

- (a) pay on demand to the Lender such additional amounts as the Lender may certify (which certificate shall be conclusive and binding on the Borrower, save for any manifest error) to be necessary to compensate the Lender for such Increased Costs; and
- (b) be at liberty at any time after its receipt of any such demand and so long as the circumstances giving rise to such Increased Costs may continue and subject to its giving to the Lender not less than 15 Business Days' prior written notice, to prepay to the Lender in whole (but not in part) the loan(s) outstanding, interest thereon and any other sums owing or payable under the Facility (subject to Paragraphs (12)(c) to (d) and (24)(a)).

Any demand as referred to in sub-paragraph (a) of this Paragraph (16) may be made at any time before or after the end of any period or any time before or after any prepayment or repayment of all or part of the Facility to which such demand relates.

**(17) Representations and Warranties:**

The Borrower represents and warrants to the Lender throughout the whole term of the Facility and for so long as any amount is outstanding under the Facility that:

- (a) The Borrower has the corporate power and authority to (i) borrow the Facility from the Lender on the terms and conditions herein and (ii) give security/indemnity/assurance as support for the borrowing of the Facility from the Lender, and no event, state of affairs, conditions or act which constitutes or with the passing of time, giving of notice, or with the fulfillment of any condition will or may constitute an Event of Default (as defined in Paragraph (19) below) has occurred or will occur on the date of making a drawing by the Borrower under the Facility or as a result thereof;
- (b) The Borrower is duly incorporated and validly existing under the laws of its place of incorporation, (ii) has full legal right, capacity, power and authority to enter into the Finance Documents to which it is party and (iii) has taken all necessary actions to authorise the borrowing of the Facility on the terms and conditions hereunder;
- (c) This Facility Letter, when signed/executed by the Borrower, will constitute legal, valid and binding obligations of the Borrower enforceable against the Borrower in accordance with the terms herein;
- (d) The Borrower's entering into this Facility Letter does not and will not violate or exceed any borrowing or similar limit or other power or restriction granted or imposed by any law to which the Borrower is subject or under its Memorandum and Articles of Association (or applicable constitutional documents);
- (e) The Borrower entering into, exercising of its rights and/or performing of or complying with its obligations under this Facility Letter does not and will not violate, to an extent or in a manner which has or is likely to have a material adverse effect on its financial condition or operation, any agreement to which it is a party or which is binding on it or its assets;

- (f) Any information (written or otherwise) provided by the Borrower in connection with the Facility and the financial condition of the Borrower is/are true and accurate as of the date of providing them;
- (g) The Borrower's obligations under this Facility Letter are direct, unconditional and unsubordinated obligations of the Borrower and rank at least pari passu with all other present and future unsecured borrowings of the Borrower, save as otherwise provided by law; and
- (h) The representations and warranties contained in sub-paragraphs (a) to (g) of this Paragraph (17) shall be deemed to be repeated and will remain to be true and accurate in all respects as if made on each date on which any amount is outstanding under the Facility or any part of the Facility remains available or subsisting.

**(18) Undertakings:**

The Borrower undertakes to the Lender throughout the whole term of the Facility and for so long as any sum remains owing or payable under the Facility that:

- (a) The Borrower shall deliver to the Lender its (i) audited consolidated financial statements as soon as available and in any event within 120 days after the end of its financial years, and (ii) interim half-year unaudited consolidated financial statements as soon as practicable and in any event within 90 days after the end of the relevant first 6-month period in its financial years;
- (b) The Borrower shall deliver to the Lender any circular, document or other information (written or otherwise) as the Lender may from time to time reasonably request;
- (c) The Borrower shall maintain its corporate existence and conduct its business and operations in compliance with all applicable laws and in a proper manner;
- (d) The Borrower shall maintain (i) 100% beneficial ownership of the issued share capital of Changyou.com HK Limited, a company incorporated in Hong Kong and having its registered office at 12th Floor, Ruttonjee House, No. 11 Duddell Street, Central, Hong Kong ("Changyou.com HK") and Beijing AmazGame Age Internet Technology Co., Ltd, a company incorporated in the People's Republic of China and having its registered office at Room 1210, Building 3, No. 3 Badachu High-tech Science Park, Shijingshan District, Beijing, the People's Republic of China ("Beijing AmazGame") and (ii) the management control of Changyou.com HK and Beijing AmazGame;

- (e) The shares of the Borrower shall remain listed on the NASDAQ Global Select Market shall not be suspended from trading on NASDAQ Global Select Market for a period exceeding consecutive 14 trading days except for obtaining approval in writing from the Lender;
- (f) The Borrower shall place RMB deposit(s) in the CorporatePlus Account for an amount equivalent to the interest payable of each drawing/advance of the next calendar quarter under the Facility within 5 Business Days from each drawing/advance throughout the loan life of the Facility and for so long as any amount remains owing or payable under the Facility;
- (g) The Borrower shall fully comply with the legal and regulatory requirements of the People's Republic of China ("PRC") on the loan usage and the flow of loan money and shall not directly or indirectly remit, transfer or channel the proceeds of the Facility to the PRC (but excluding Hong Kong, Macau and Taiwan);
- (h) The Borrower shall forthwith notify the Lender in writing of (i) the occurrence of any Event of Default as referred to in Paragraph (19) below and/or (ii) the occurrence of any event, state of affairs, conditions or act which with the passing of time, giving of notice, or with the fulfillment of any condition will or may constitute an Event of Default; and
- (i) The Borrower shall promptly upon the request of the Lender supply, or procure the supply of, such documentation and other evidence as is reasonably requested by the Lender in order for the Lender to conduct any "Know Your Customer" or other similar procedures under applicable laws and regulations.

**(19) Events of Default:**

Upon the occurrence of any of the following events at any time (each an "Event of Default"):

- (a) The Borrower or the Issuing Bank fails to pay on the due date to the Lender any sum (including but not limited to any repayment of principal and interest payment) that the Borrower or the Issuing Bank is obliged to pay in connection with the Facility; or

- (b) The Borrower or the Issuing Bank defaults in the performance of any other obligations hereunder and/or under the Finance Documents (as the case may be); or
- (c) The Borrower or the Issuing Bank becomes insolvent or any liquidator/trustee in bankruptcy or receiver has been appointed over all or part of the assets of the Borrower or the Borrower is unable or admits inability to pay its debts as they fall due; or
- (d) There occurs, in the opinion of the Lender, a material adverse change in the financial condition of the Borrower or the Issuing Bank or there occurs, in the opinion of the Lender, any situation which has materially and adversely affected or may materially and adversely affect the ability of the Borrower to perform any or all of its obligations hereunder; or
- (e) A petition is presented or a proceeding is commenced or an order is made or an effective resolution is passed or any other step is taken by any person for the winding-up, insolvency, administration, reorganization, reconstruction, dissolution or bankruptcy of the Borrower or the Issuing Bank or for the appointment of a liquidator, receiver, administrator, trustee or similar officer of the Borrower or the Issuing Bank or of all or any part of its business or assets; or
- (f) Any indebtedness of the Borrower or the Issuing Bank becomes due before its stated maturity or when called, or the Borrower or the Issuing Bank defaults under or commits a breach of any instrument or agreement relating to any such indebtedness; or
- (g) Any step is taken by any person for the purpose of a reconstruction, amalgamation, reorganization, merger or take-over involving the Borrower or the Issuing Bank (except for a solvent merger or take-over on terms approved by the Lender in writing before such step is taken); or
- (h) The Borrower ceases to maintain (i) 100% beneficial ownership of the issued share capital of Changyou.com HK and Beijing AmazGame and (ii) the management control of Changyou.com HK and Beijing AmazGame; or
- (i) The shares of the Borrower, for any reason (other than technical in nature as determined by the Lender in its sole discretion) cease or are suspended from trading on NASDAQ Global Select Market for more than 14 consecutive trading days except for obtaining approval in writing from the Lender; or

- (j) Any representation, warranty, undertaking or statement made by the Borrower hereunder is not complied with or is or proved to be incorrect or misleading in any material respect when made, repeated or deemed to be repeated; or
- (k) There occurs any event or circumstance which, with the giving of notice and/or the lapse of time and/or the making of any necessary determination under this Facility Letter and/or the satisfaction of any applicable condition, or any combination of any of the foregoing might constitute an Event of Default;

then the Lender may, at any time when any one of the above-mentioned Events of Default occurs and/or is continuing, terminate the Facility and demand immediate payment and/or repayment of all amounts outstanding (together with interest accrued thereon and any other amounts owing to the Lender) under or in connection with the Facility from the Borrower whereupon the security constituted by the Finance Documents shall forthwith become enforceable without prior notice.

This Paragraph (19) is without prejudice to the Lender's overriding rights as set out in Paragraph (13) above.

**(20) Set-off:**

- (a) The Borrower hereby irrevocably authorises the Lender to apply (without prior notice) any credit balance (whether or not then due) to which the Borrower is at any time beneficially entitled on any account at, any sum held to the order of the Borrower by and/or any liability of any office of the Lender, either singly or jointly, in or towards satisfaction of any sum then due from the Borrower to the Lender in connection with the Facility and unpaid. For this purpose, the Lender is authorised to use all or any part of any such credit balance to buy such other currencies as may be necessary to effect such application.
- (b) The Lender shall not be obliged to exercise any of its rights under this Paragraph (20), which shall be without prejudice and in addition to any right of set-off, combination of accounts, lien or other right to which it is at any time otherwise entitled (whether by operation of law, contract or otherwise).

**(21) Severability:**

Any provision of this Facility Letter prohibited by or becoming unlawful or unenforceable under any applicable law actually applied by any court of competent jurisdiction shall, to the extent required by such law, be severed from this Facility Letter and be rendered ineffective so far as is possible without modifying the remaining provisions of this Facility Letter. Where, however the provisions of any such applicable law may be waived, they are hereby waived by the parties hereto to the full extent permitted by such law to the effect that this Facility Letter shall be a valid and binding agreement enforceable in accordance with its terms.

**(22) Entire Agreement:**

This Facility Letter constitutes the entire agreement of the Lender and the Borrower and supersedes any previous expressions of intent or understanding in respect of the Facility.

**(23) Expenses:**

All costs, charges, taxes, fees and expenses (including legal fee on a full indemnity basis) incurred by the Lender in connection with the preparation, negotiation, administration, execution, perfection, enforcement and/or amendment of, supplement to or waiver in respect of the Finance Documents and all other relevant documents or otherwise in connection with the Facility shall be borne and paid by the Borrower on demand, irrespective of whether or not any part of the Facility is subsequently utilized.

**(24) Indemnity:**

- (a) The Borrower shall on demand indemnify the Lender in full against any cost, loss, expense, tax, fee, claims, proceeding or liability whatsoever incurred, suffered or sustained and as conclusively certified by the Lender as a result of (i) any drawing not being made following the giving of a notice of drawing by the Borrower due to non-fulfillment of any condition of this Facility Letter, or (ii) the making of any drawing pursuant to this Facility Letter or otherwise, or (iii) any prepayment under the Facility on a non-Interest Payment Date.

- (b) If any amount is received or recovered in a currency other than the currency (the “Account Currency”) in which payment has been demanded pursuant to the Finance Documents (whether as a result of, or of the enforcement of, a judgment or order of a court, tribunal or authority of any jurisdiction, or in the dissolution of the Borrower or otherwise), it shall only constitute a discharge by the Borrower to the extent of the amount in the Account Currency which the Lender is able to purchase with the amount so received or recovered in that other currency on the date of receipt or recovery. If that amount is less than the Account Currency amount expressed to be due to the Lender, the Borrower shall on demand indemnify the Lender against any loss/shortfall sustained by it as a result.

**(25) Evidence:**

Any certificate issued by the Lender as to the amount of the loan(s) outstanding, the rate of interest applicable to the amount of any sums owing or payable in connection with the Facility or any other matters relating to this Facility Letter shall, save to the extent of manifest error, be conclusive evidence against the Borrower as to the matter(s) covered thereby.

**(26) Process Agent:**

The Borrower irrevocably appoints Changyou.com HK to be its agent (the “Process Agent”) for the service of process in Hong Kong. Any documentation in connection with the proceedings in the courts of Hong Kong delivered to the Process Agent at its registered office from time to time shall be treated as duly delivered to and served on the Borrower. The Borrower shall procure the Process Agent to forthwith notify the Lender in writing of any change in the address of its registered office.

**(27) Governing Law and Jurisdiction:**

This Facility Letter and all other relevant documents and the rights and obligations of the Lender and the Borrower hereunder/thereunder shall be governed by and construed in accordance with the laws of the Hong Kong Special Administrative Region of the People’s Republic of China (“Hong Kong”) and each party hereto hereby irrevocably submits to the non-exclusive jurisdiction of the courts of Hong Kong.

**(28) Miscellaneous:**

- (a) Reference to the time of a day is to Hong Kong time (unless otherwise stated), and time is of the essence hereof;



- (b) “Business Day” as used in this Facility Letter means a day (other than Saturday and Sunday) on which dealings in RMB may be carried out in the relevant interbank market and on which banks are generally open for business in Hong Kong and the PRC;
- (c) For the purpose of this Facility Letter, any determination as to whether any event, situation, circumstance or document is “material”, “adverse”, “reasonable”, “expedient” or “necessary” shall be determined by the Lender whose determination shall be conclusive and binding on the Borrower; and
- (d) Headings on this Facility Letter are for ease of reference only and shall not affect the interpretation of the terms and conditions of this Facility Letter.

Please signify your acceptance of the above terms and conditions by signing and returning to us the duplicate of this Facility Letter within 1 month from the date hereof, failing which our offer will automatically lapse. Upon our receipt of your acceptance of this Facility Letter, this Facility Letter will be legally binding upon your goodselves as the Borrower and this Bank as the Lender with immediate effect.

If you have any query in relation to the terms and conditions of this Facility Letter, please feel free to contact our Christine Wong or Lawrence Tang of Corporate Lending and Syndication Department at 3608 0968 or 3608 0923.

Yours faithfully,  
For and on behalf of  
The Bank of East Asia, Limited

Jennifer Leung  
Officer  
Trade and Loan Services Department  
Operations Support Division

Sally Lam  
Senior Credit Administration Manager

In consideration of the Lender agreeing to grant to the Borrower the Facility pursuant to the terms and conditions of this Facility Letter:-

The Borrower

We hereby agree to be bound by and accept all the terms and conditions of this Facility Letter.

For and on behalf of  
Changyou.com Limited

\_\_\_\_\_  
Name:

Date:

Witness:

The Process Agent

We hereby agree to the appointment as the Process Agent of the Borrower in accordance with Paragraph (26) of this Facility Letter.

For and on behalf of  
Changyou.com HK Limited

\_\_\_\_\_  
Name:

Date:

Witness:



Our Ref. : LC-2012005413826-6547  
To : Changyou.com HK Limited

Date : 7 August 2012

**Important Notice:** This letter sets out the terms and conditions upon which our bank would provide/continue/revise general banking facilities to you. The Borrower(s), Mortgagor(s), Chargor(s) and Guarantor(s) are advised to read and understand the terms and conditions herein carefully before accepting the banking facilities. The Borrower(s), Mortgagor(s), Chargor(s) and Guarantor(s) are entitled to seek separate independent legal advice from solicitors of their choice if they wish to understand the legal commitments which they will assume on signing this letter.

Dear Sirs,

**Re: General Banking Facilities**

With reference to our recent discussion, we, **Bank of Communications Co., Ltd. Hong Kong Branch**, are pleased to grant the following facilities (the "Facilities") to Changyou.com HK Limited with Certificate of Incorporation No.1158141 (the "Borrower") subject to the General Agreement for Banking Facilities and the terms stated below. Words and expressions defined in the General Agreement for Banking Facilities shall have the same meaning in this letter.

**1. Facilities**

• **Uncommitted Term Loan**

Limit: USD100,000,000.00\*\*\*

Remarks:

- (1) Availability Period: The proposed date of each advance must be a business day and the Term Loan facility shall be available for drawdown within 10 months from the acceptance date of this facility letter subject to the Bank's satisfaction of all conditions precedent under this facility letter ("Availability Period").
- (2) The utilization and withholding of the Facilities will be subject to the terms and conditions under the "暢游(香港)有限公司申請貸款之四方操作協議" (as defined under clause 2 of this letter, the "四方協議").
- (3) Maximum amount of each advance in aggregate with the other term advances made under the Facilities shall not exceed 100% of the amount of the corresponding 確認函 issued by Bank of Communications Co., Ltd. Beijing Municipal Branch ("BoCom Beijing") and shall not at any time exceed USD100,000,000.00.
- (4) Supporting documents evidencing the purpose of utilization of the drawdown proceeds in form and substance satisfactory to the Bank shall be provided to the Bank within one month from the drawdown date of each term advance.
- (5) Each drawdown request shall be made by the Borrower in writing at least two (2) business days prior to the proposed date of advance.
- (6) The drawdown notice once given is irrevocable.
- (7) Interest rate: at 2.2% p.a. over LIBOR.
- (8) Interest Period: two (2) weeks, one (1), three (3) or (subject to availability) six (6) months as mutually agreed between the Borrower and the Bank from time to time in writing. No interest period shall extend beyond the Maturity Date.
- (9) The Bank is hereby authorized and instructed by the Borrower to deduct an amount equal to 3% of each advance for interest payment of the Facilities due and to be payable by the Borrower to the Bank (the "Retention Amount") from the drawdown proceeds upon each drawdown. The Retention Amount shall be deposited and withheld in the Borrower's designated account maintained with the Bank.
- (10) Each drawdown shall be made in minimum amount of USD5,000,000.00 and in integral multiples of USD1,000,000.00.

交通銀行股份有限公司香港分行(於中華人民共和國註冊成立)  
Bank of Communications Co., Ltd. Hong Kong Branch (Incorporated in the People's Republic of China)

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放款中心 香港灣仔告士打道 231 - 235 號交通銀行大廈 8 樓  
Loans Centre 8/F., Bank of Communications Tower, 231-235 Gloucester Road, Wan Chai, Hong Kong.  
電話 Tel : (852) 2162 2162 傳真 Fax : (852) 2851 8600

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Our Ref. : LC-2012005413826-6547

To : Changyou.com HK Limited

- (11) Interest of each advance shall be payable at the end of its relevant interest period. All outstanding principal, accrued interests and any other monies owing under the Facilities shall be repaid in full on the Maturity Date.
- (12) Default Interest: 4.25% p.a. (the Default Margin) over the USD Best Lending Rate of the Bank.
- (13) Any amounts undrawn after the Availability Period shall be automatically cancelled.
- (14) The "Maturity Date" shall mean the earliest of
  - (i) the date falling two (2) years from the acceptance date of this facility letter or
  - (ii) the date falling one month before the expiry date of the corresponding 確認函 issued by BoCom Beijing or
  - (iii) from the first anniversary of the first drawdown date of the Facilities, the "Maturity Date" (which shall be absolutely determined by the Bank) as notified in writing by the Bank to the Borrower whereupon all outstanding principal, accrued interests and any other monies owing under the Facilities shall be repaid in full by the Borrower.
- (15) Prepayment in whole or in part is allowed subject to five (5) business days' prior written notice to the Bank. The Borrower shall pay all break funding costs incurred by the Bank if prepayment is not made on an interest payment date. Amount prepaid cannot be re-borrowed.
- (16) If any interest period shall end on a day which is not a business day, such interest period shall end on the next succeeding business day unless such succeeding business day falls within the next calendar month in which case such interest period shall end on the immediately preceding business day and interest shall be adjusted accordingly.
- (17) Under any circumstances, the Bank shall have the sole discretion to decide whether to make available such advance(s) or not.

## 2. Conditions Precedent / Collateral Securities

- The following collateral securities and/or legal documents shall be provided : -
  - Duplicate copy of this facility letter to be duly accepted and executed by the Borrower, the Guarantor(s) and/or the Security Provider(s) (as the case may be).
  - General Agreement for Banking Facilities duly accepted and executed by the Borrower.
  - Certified extract of board resolutions (and shareholders' minutes where appropriate) from the relevant parties approving the terms of this letter, the General Agreement for Banking Facilities and other condition precedent documents.
  - 暢遊(香港)有限公司申請貸款之四方操作協議 (Master Agreement no.LC-2012005413826A-6547) duly accepted and executed by the Borrower, 北京暢遊天下網絡技術有限公司, Bank of Communications Co., Ltd. Hong Kong Branch and Bank of Communications Co., Ltd. Beijing Municipal Branch (the "四方協議").
  - Letter of confirmation (確認函) issued by Bank of Communications Co., Ltd. Beijing Municipal Branch in form and substance satisfactory to the Bank.
  - Letter of Undertaking (承諾函) issued by the Borrower in form and substance satisfactory to the Bank.
  - The original audited consolidated annual financial statements of 北京暢遊天下網絡技術有限公司 or copies of such audited consolidated annual financial statements duly certified by the director of 北京暢遊天下網絡技術有限公司 for the financial year 2011.
- In respect of any or all documents supplied by you to us in support of your credit application, you shall, upon our request, produce the originals of such documents for our inspection.
- Such other documents as we may reasonable request including without limitation those as may be required to evidence any and all licenses, authorization, consents or approvals, necessary for the performance by you or the security provider(s) of their respective obligations under this letter and the security or condition precedent documents.

## 3. Fees & Expenses

- Handling charge of 0.4% on the Term Loan limit made available to the Borrower (the "Available Limit") shall be payable by the Borrower on the date which each such Available Limit is made available to the Borrower.

Our Ref. : LC-2012005413826-6547

To : Changyou.com HK Limited

- Whether or not the Facilities are drawn or utilized by you, all reasonable expenses including but not limited to legal fees, communications and other out-of-pocket expenses reasonably incurred by us in connection with the Facilities or other documents executed in respect of the Facilities or any enforcement, or attempted enforcement, of our rights under this facility letter or other documents executed in respect of the Facilities, are to be borne by you on a full indemnity basis.
- We reserve the right to charge you administrative charge of **HKD200.00** or such other reasonable amount as determined by us from time to time, each time when you fail to make a payment on its due date.
- Apart from all costs, expenses, administrative charge and default interest (if applicable) arising from your failure to make payment on its due date, the Bank reserves the right to charge you collection charge of **HKD1,500.00** (or such other reasonable amount as determined by the Bank from time to time) upon each issuance of solicitor's demand letter to you and/or the security provider(s). This collection charge shall be borne by you on a full indemnity basis.
- Unless agreed by us, all monies paid under this Clause 3 shall not be refunded once paid.

#### 4. Authorization to debit account(s)

- We shall be authorized to debit any account opened or to be opened with the Bank in name of Changyou.com HK Limited at any time and from time to time for all or any of the instalment payment, interest, fees, charges, commissions, costs, expenses and other sums due and payable by the captioned Borrower(s) without prior notice to the captioned account holder. Such sums shall be deemed duly drawn or overdrawn from the captioned account(s) by the captioned account holder. The captioned account holder hereby agree and guarantee that all payments from the captioned debited account in payment of any indebtedness of the Borrowers shall not confer any right, whether by way of subrogation or otherwise, on the captioned account holder in respect of any security now or at any time hereafter, and from time to time given by the Borrowers/Chargor(s)/Guarantor(s) to us in respect of any of the captioned Banking Facilities.

#### 5. Other Conditions

5.1 The Borrower hereby undertakes with the Bank that for so long as any moneys are owing under this facility letter or any part of the Facilities commitment remains outstanding :-

- (a) the Borrower shall directly and beneficially own 100% shareholding interests in 北京暢遊天下網絡技術有限公司 at all times;
- (b) to procure 北京暢遊天下網絡技術有限公司 shall be remained as the business profit center of the Borrower's group companies in PRC;
- (c) to procure the annual dividend payment or other profit distribution of 北京暢遊天下網絡技術有限公司 in an amount of not less than the aggregate of all outstanding principal, accrued interests and any other monies owing under the Facilities shall be credited to the designated account of the Borrower maintained with the Bank and such dividend distribution shall not be under any kind of restriction from any other third party;
- (d) to procure Changyou.com Limited shall maintain its listing status on NASDAQ and shall directly and beneficially hold 100% shareholding interest in the Borrower at all times;
- (e) to procure the distributable profits of 北京暢遊天下網絡技術有限公司 shall not be less than RMB3,500,000,000.00 for financial year 2012.
- (f) to procure 北京暢遊天下網絡技術有限公司 shall have commenced all regulatory procedures and other necessary applications for its dividend distribution on the earlier of (i) the date falling eight months from the first drawdown date under the Facilities and (ii) 31 May 2013 and the related application progress report shall be submitted to the Bank every six months;
- (g) the banking facilities granted by the financial institutions to the Borrower under which the related facilities agreements have certain restrictions on dividend distribution of 北京暢遊天下網絡技術有限公司 shall not in aggregate exceed USD500,000,000.00 (including the Facilities to the Borrower under this Facility Letter and the USD200,000,000 facilities granted by the Bank to Changyou.com Limited);
- (h) the audited financial statements or management accounts of 北京暢遊天下網絡技術有限公司 shall be submitted to the Bank every 6 months;
- (i) to procure 北京暢遊天下網絡技術有限公司 to provide the Bank with the semi-annual report on all outstanding banking facilities and the respective loan maturity date which related facilities agreements have certain restrictions on dividend distribution of 北京暢遊天下網絡技術有限公司.

交通銀行股份有限公司 香港分行 (於中華人民共和國註冊成立)  
Bank of Communications Co., Ltd. Hong Kong Branch (Incorporated in the People's Republic of China)

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放款中心 香港灣仔告士打道 231 - 235 號交通銀行大廈 8 樓  
Loans Centre 8/F., Bank of Communications Tower, 231-235 Gloucester Road, Wan Chai, Hong Kong.  
電話 Tel : (852) 2162 2162 傳真 Fax : (852) 2851 8600

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Our Ref. : LC-2012005413826-6547

To : Changyou.com HK Limited

- 5.2 The Facilities shall become immediately due and payable by the Borrower if the Borrower defaults or receives notice of default under any agreement or obligation relating to borrowing or any indebtedness of the Borrower or such borrowing or indebtedness becomes payable or capable of being declared payable before its stated maturity or is not paid when due or any encumbrance, guarantee or other security now or hereafter created by the Borrower becomes enforceable.
- 5.3 The Borrower hereby confirms and agrees that if the undistributed profits of 北京暢遊天下網絡技術有限公司 minus the outstanding banking facilities granted by other financial institutions to the Borrower under which the related facilities agreements have certain restrictions on dividend distribution of 北京暢遊天下網絡技術有限公司 is less than 1.5 times of the outstanding loan under the Facilities in this Facility Letter, the Borrower shall procure that 北京暢遊天下網絡技術有限公司 must immediately commence all regulatory procedures and other necessary applications for its dividend distribution.

## 6. Miscellaneous

- The drawdown date of any facilities must be made on a Business Day.
- You, as the Borrower of the Facilities, hereby consent that in the case of a remittance transaction at your request, our Bank is authorized to disclose your relevant information to, or used and retained by the receiving bank (whether within or outside Hong Kong) including but not limited to your company name, account number, address/registered office, date of establishment, business registration certificate number/company number etc. (if applicable).
- You confirm that, at present, you do not have any relationship with any of the directors or employees of our Bank or any other subsidiaries of our Bank. If the Facilities are secured by any guarantee(s) or securities provided by any third party(ies) (the "Security Provider"), you also confirm that none of the Security Provider is so related. You further agree and undertake that if the foregoing is not true and correct or you or any of the Security Provider becomes related with any of the directors or employees of our Bank or any other subsidiaries of our Bank, you will promptly notify us in writing.
- If there is any conflict or inconsistency between the (provisions) hereof and the provision(s) of the General Agreement for Banking Facilities and other collateral securities it is agreed that the provision(s) hereof shall prevail.

## 7. Date of Review

- Unless the Facilities are cancelled by us, they are subject to our review on a regular basis.

交通銀行股份有限公司 香港分行 (於中華人民共和國註冊成立)  
Bank of Communications Co., Ltd. Hong Kong Branch (Incorporated in the People's Republic of China)

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放款中心 香港灣仔告士打道 231 - 235 號交通銀行大廈 8 樓  
Loans Centre 8/F., Bank of Communications Tower, 231-235 Gloucester Road, Wan Chai, Hong Kong.  
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Our Ref. : LC-2012005413826-6547  
To : Changyou.com HK Limited

Please signify your acceptance of this offer by signing and returning to us duplicate copy of this facility letter within 30 days from the date of this letter, failing which this offer shall lapse. Further, if the condition precedent and security documents listed above are not provided to us to our satisfaction within 30 days from your acceptance of this offer, the Facilities will not be made available to you or subject to our review of the terms and conditions thereof by notice to you.

We hope you would avail yourself the banking facilities frequently to our mutual benefit and we assure you of our best services at all times.

Yours faithfully,  
For **Bank of Communications Co., Ltd.**  
**Hong Kong Branch**

\_\_\_\_\_  
Authorized Signature(s)

After due and careful consideration of the contents of this facility letter, I/we hereby accept the Facilities and agree to be bound by the terms and conditions set out herein.

在細心考慮本授信函內容後，本人／吾等在此同意接受授信函並受本授信函所載之條款及條件所約束。

For and on behalf of  
Changyou.com HK Limited

\_\_\_\_\_  
Borrower  
借款人  
Date:  
日期

\_\_\_\_\_  
Witness:  
見證人

交通銀行股份有限公司香港分行（於中華人民共和國註冊成立）  
Bank of Communications Co., Ltd. Hong Kong Branch (Incorporated in the People's Republic of China)

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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 8, 2012

/s/ Charles Zhang

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 8, 2012

/s/ Carol Yu

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, 2012 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, 2012 and results of operations of the Company for the three months ended September 30, 2012.

/s/ Charles Zhang

Charles Zhang, Chief Executive Officer and Chairman of the  
Board of Directors  
November 8, 2012

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, 2012 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, 2012 and results of operations of the Company for the three months ended September 30, 2012.

/s/ Carol Yu

Carol Yu, Co-President and Chief Financial Officer  
November 8, 2012