MARCHEX INC
Form 10-Q
November 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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 000-50658

Marchex, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**35-2194038**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

413 Pine Street, Suite 500

Seattle, Washington 98101

(Address of principal executive offices)

Registrant s telephone number, including area code: (206) 331-3300

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 and 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 x No ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date.

Class	Outstanding at November 7, 2006
Class A common stock, par value $.01	11,659,216
Class B common stock, par value $.01	27,469,825

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Marchex, Inc.

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Part I Financial Information

Item 1. Condensed Consolidated Financial Statements (unaudited)

MARCHEX, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(unaudited)

	December 31, 2005	September 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 63,090,941	$ 69,334,818
Accounts receivable, net	14,401,814	14,539,441
Prepaid expenses and other current assets	1,818,211	2,400,316
Refundable taxes	3,835,542	3,146,204
Deferred income tax assets	428,855	358,081
Total current assets	83,575,363	89,778,860
Property and equipment, net	3,402,262	7,331,859
Deferred income tax assets		2,121,944
Intangible and other assets, net	15,447,504	12,984,003
Goodwill	180,637,076	200,742,308
Intangible assets from acquisitions, net	51,346,944	42,127,241
Total assets	$ 334,409,149	$ 355,086,215
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 9,258,423	$ 9,052,542
Accrued expenses and other current liabilities	1,755,970	2,149,649
Deferred revenue	2,291,374	2,491,013
Total current liabilities	13,305,767	13,693,204
Deferred income tax liabilities	397,481	
Other non-current liabilities	92,309	98,076
Total liabilities	13,795,557	13,791,280
Commitments and contingencies		
Stockholders equity:		
Convertible preferred stock	54,121,678	34,116,491
Class A common stock	119,282	119,217
Class B common stock	254,839	274,651
Additional paid-in capital	271,949,963	311,932,041
Deferred stock-based compensation	(3,042,016)	
Accumulated deficit	(2,790,154)	(5,147,465)
Total stockholders equity	320,613,592	341,294,935

Total liabilities and stockholders equity	$ 334,409,149	$ 355,086,215

See accompanying notes to condensed consolidated financial statements.

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MARCHEX, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

(unaudited)

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Revenue	$ 65,191,682	$ 95,153,161	$ 25,627,677	$ 32,326,116
Expenses:				
Service costs (1), (2)	34,822,513	45,056,393	13,280,344	15,184,125
Sales and marketing (1), (2)	6,382,121	17,236,349	3,197,809	5,962,465
Product development (1), (2)	3,252,001	7,470,331	1,038,257	2,689,912
General and administrative (1), (2)	4,841,571	10,364,929	1,870,984	3,109,209
Amortization of intangible assets from acquisitions (3)	13,224,507	15,343,966	5,191,699	5,309,102
Total operating expenses	62,522,713	95,471,968	24,579,093	32,254,813
Gain (loss) on sales and disposals of intangible assets, net		284,766		(68,513)
Income (loss) from operations	2,668,969	(34,041)	1,048,584	2,790
Other income (expense):				
Interest income	1,390,332	2,323,415	533,976	831,005
Interest expense	(5,393)	(6,280)	(1,933)	(1,841)
Other	4,000	(9,764)		(7,901)
Total other income	1,388,939	2,307,371	532,043	821,263
Income before provision for income taxes	4,057,908	2,273,330	1,580,627	824,053
Income tax expense	1,820,866	2,305,247	871,277	812,795
Income (loss) before cumulative effect of change in accounting principle	2,237,042	(31,917)	709,350	11,258
Cumulative effect of a change in accounting principle, net of tax		151,341		
Net income	2,237,042	119,424	709,350	11,258
Convertible preferred stock dividends and conversion payment	1,714,619	2,338,229	682,813	422,147
Net income (loss) applicable to common stockholders	$ 522,423	$ (2,218,805)	$ 26,537	$ (410,889)
Basic net income (loss) applicable to common stockholders	$ 0.02	$ (0.06)	$ 0.00	$ (0.01)
Diluted net income (loss) applicable to common stockholders	$ 0.01	$ (0.06)	$ 0.00	$ (0.01)
Shares used to calculate basic net income (loss) per share applicable to common stockholders	33,886,928	38,065,347	36,043,092	38,720,191
Shares used to calculate diluted net income (loss) per share applicable to common stockholders	36,188,819	38,065,347	38,144,506	38,720,191

(1) Excludes amortization of intangible assets from acquisitions

(2) Includes stock-based compensation as follows:				
Service costs	$ 3,600	$ 760,607	$ (131,034)	$ 268,654
Sales and marketing	753,414	2,836,843	437,983	845,594
Product development	22,755	2,446,530	(125,895)	884,156
General and administrative	421,896	4,113,376	376,904	1,210,301
Total stock-based compensation	$ 1,201,665	$ 10,157,356	$ 557,958	$ 3,208,705

(3) Components of amortization of intangible assets from acquisitions:				
Service costs	$ 10,079,097	$ 10,441,008	$ 3,795,373	$ 3,595,177
Sales and marketing	774,166	1,921,057	448,611	732,473
General and administrative	2,371,244	2,981,901	947,715	981,452
Total amortization of intangible assets form acquisitions	$ 13,224,507	$ 15,343,966	$ 5,191,699	$ 5,309,102

See accompanying notes to condensed consolidated financial statements.

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MARCHEX, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(unaudited)

	Nine months ended September 30, 2005	Nine months ended September 30, 2006
Cash flows from operating activities:		
Net income	$ 2,237,042	$ 119,424
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of a change in accounting principle		(151,341)
Amortization and depreciation	16,167,325	19,677,510
Facility relocation recoveries	(36,690)	(43,431)
Gain (loss) on sales of fixed assets	(4,000)	9,764
Gain on sales and disposals of intangible assets, net		(284,766)
Allowance for doubtful accounts and merchant advertiser credits	1,441,503	1,280,645
Stock-based compensation	1,201,665	10,157,356
Deferred income taxes	(2,238,696)	(2,473,582)
Income tax benefit related to stock options	798,162	
Excess tax benefit related to stock options		(2,025,351)
Change in certain assets and liabilities, net of acquisitions:		
Trade accounts receivable, net	(5,655,212)	(1,418,272)
Refundable taxes	(1,966,356)	2,798,658
Prepaid expenses, other current assets, and restricted cash	(1,400,541)	(916,447)
Accounts payable	(742,932)	(397,390)
Accrued expenses and other current liabilities	707,967	290,394
Deferred revenue	29,496	197,859
Acquisition-related retention consideration in earn-out liability	(501,769)	
Other non current liabilities	31,666	12,789
Net cash provided by operating activities	10,068,630	26,833,819
Cash flows from investing activities:		
Purchases of property and equipment	(1,456,883)	(5,010,864)
Cash paid, net of recoveries, for acquisitions and earn-outs	(189,282,667)	(17,875,318)
Proceeds from sales of property and equipment	4,000	2,170
Proceeds from sales of intangible assets	687,036	1,570,445
Increase in other non current assets	(16,591,145)	(674,238)
Net cash used in investing activities	(206,639,659)	(21,987,805)
Cash flows from financing activities:		
Capital lease obligation principal paid	(5,980)	(8,811)
Excess tax benefit related to stock options		2,025,351
Offering costs paid	(907,058)	
Preferred stock dividends and conversion payment	(1,373,100)	(2,476,735)
Proceeds from public offering, net of underwriter discounts	230,287,500	
Proceeds from exercises of stock options	630,778	1,802,168
Proceeds from employee stock purchase plan	175,744	55,890
Net cash provided by financing activities	228,807,884	1,397,863
Net increase in cash and cash equivalents	32,236,855	6,243,877

Cash and cash equivalents at beginning of period		24,933,066		63,090,941
Cash and cash equivalents at end of period	$	57,169,921	$	69,334,818

See accompanying notes to condensed consolidated financial statements.

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Marchex, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(1) Description of Business and Basis of Presentation

Marchex, Inc. (the Company) was incorporated in the state of Delaware on January 17, 2003. The Company offers a platform of performance-based advertising and search marketing services which enable merchants to market and sell their products across multiple distribution channels, including search engines, product shopping engines, directories and selected Web sites. The Company also offers super-aggregators and publishers outsourced search marketing platforms, which are a combination of several of the Company s advertiser technology services, to allow them to sell search marketing packages directly to their customers.

The accompanying unaudited condensed consolidated financial statements of Marchex, Inc. and subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006, or for any other period. The balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date but does not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company s audited consolidated financial statements and accompanying notes included in the Annual Report on Form 10-KSB for the year ended December 31, 2005 filed with the SEC.

The condensed consolidated financial statements include the accounts of Marchex and its wholly-owned subsidiaries. Acquisitions are included in the Company s consolidated financial statements as of the date of acquisition. The Company s purchase accounting resulted in all assets and liabilities of acquired businesses being recorded at their estimated fair values on the acquisition dates. All significant inter-company transactions and balances have been eliminated in consolidation.

The Company s condensed consolidated financial statements presented include the balance sheets as of December 31, 2005 and September 30, 2006, the consolidated statements of operations for the three and nine months ended September 30, 2005 and 2006, and the consolidated statements of cash flows for the nine months ended September 30, 2005 and 2006.

Certain reclassifications have been made to the prior year condensed consolidated financial statements to conform to the current year presentation.

Acquisitions

The Company has completed the following acquisitions since January 1, 2004 and has accounted for them as business combinations:

On July 27, 2004, the Company acquired 100% of the outstanding stock of goClick.com, Inc. (goClick), a Norwalk, Connecticut-based company. goClick provided marketing technology and services for small merchants.

On February 14, 2005, the Company acquired substantially all of the assets of Name Development Ltd. (Name Development) including its portfolio of Internet domains and Web sites, revenue-generating contracts, technology and systems, for the operation of the Name Development direct navigation business.

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On April 26, 2005, the Company acquired certain assets of Pike Street Industries, Inc. (Pike Street), an online yellow pages and lead generation provider for local merchants.

On July 27, 2005, the Company acquired 100% of the outstanding stock of IndustryBrains, Inc. (IndustryBrains), a company focused on monetizing Web sites through contextual advertising solutions.

On May 1, 2006, the Company acquired certain assets of AreaConnect LLC (AreaConnect), a provider of local online traffic to Yellow and White Pages publishers.

On May 26, 2006, the Company acquired certain assets of Open List, Inc. (Open List), including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform.

(2) Significant Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These judgments are difficult as matters that are inherently uncertain directly impact their valuation and accounting. Actual results may vary from management s estimates and assumptions.

The Company s significant accounting policies are disclosed in the Company s Annual Report on Form 10-KSB for the year ended December 31, 2005 filed with the SEC.

Stock-based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123-R (SFAS 123R), *Share-Based Payment*, which replaced Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation,* and supersedes Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock issued to Employees*. The adoption of SFAS 123R had a material impact on the Company s consolidated financial statements. See Note 3 Stock-based Compensation Plans for further information regarding the Company s adoption of SFAS 123R, including pro forma disclosure for the prior period as if the Company recorded stock-based compensation expense on a fair value basis estimated in accordance with the pro forma provisions of SFAS 123.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to application of SFAS 123R. In accordance with SAB 107, the Company will no longer present stock-based compensation separately on the consolidated statements of operations but will present stock-based compensation in the same lines as compensation paid to the same individuals.

Recently Issued Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* This pronouncement prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in the Company s tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning January 1, 2007. The Company is in the process of evaluating the effect of the adoption of FIN 48 will have on its financial statements.

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In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 will be effective for the Company for the fiscal year ended December 31, 2006. The Company does not believe that the adoption of SAB 108 will have a material impact on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements,* which clarifies the definition of fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is in the process of evaluating the effect that SFAS 157 will have on its financial statements.

Revenues

The following table presents our revenues, by revenue source, for the periods presented:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Proprietary Traffic Sources	$ 16,789,402	$ 34,637,969	$ 7,762,225	$ 12,261,956
Partner and Other Revenue Sources	48,402,280	60,515,192	17,865,452	20,064,160
Total Revenue	$ 65,191,682	$ 95,153,161	$ 25,627,677	$ 32,326,116

The Company s proprietary traffic revenues are generated from the Company s portfolio of owned Web sites which are monetized with pay-per-click and cost-per-action listings and graphical ad units that are relevant to the Web sites. When an online user navigates to one of the Company s owned and operated Web sites and clicks on a particular listing or completes the specified action, the Company receives a fee.

The Company s partner network revenues are primarily generated using third-party distribution networks to deliver the merchant advertisers listings. The distribution network includes search engines, shopping engines, directories, destination sites, Internet domains or Web sites, and other targeted Web-based content. The Company generates revenue upon delivery of qualified and reported click-throughs to the Company s merchant advertisers or to advertising services providers listings. The Company pays a revenue share to the distribution partners to access their online user traffic. Other revenues include the Company s bid management services, natural search optimization services and outsourced search marketing platforms.

(3) Stock-based Compensation Plans

(a) Stock Option Plan and Issuance of Restricted Class B Common Stock

In January 2003, the Company adopted a stock incentive plan (the Plan) pursuant to which the Plan s Administrative Committee, appointed by the Company s Board of Directors, may grant both stock options and restricted stock awards to employees, officers, non-employee directors, and consultants and such options may be designated as incentive or non-qualified stock options at the discretion of the Administrative Committee. The Plan authorizes grants of options to purchase up to 4,000,000 shares of authorized but unissued Class B common stock and provides for the total number of shares of Class B common stock for which options designated as incentive stock options may be granted shall not exceed 8,000,000 shares. Annual increases are to be added on the first day of each fiscal year beginning on January 1, 2004 equal to 5% of the outstanding common stock (including for this purpose any shares of common stock issuable upon conversion of any outstanding capital stock of the Company). As a result of this provision, the authorized number of shares available under this Plan

was increased by 1,013,953 to 5,013,953 on January 1, 2004 and by 1,274,948 to 6,288,901 on January 1, 2005 and by 1,972,526 to 8,261,427 on January 1, 2006. The Company issues new shares and shares from treasury for shares delivered under the Plan and restricted stock grants. Generally, stock options have 10-year terms and vest 25% each year either annually or quarterly, over a 4 year period.

SFAS 123 established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As originally issued, SFAS 123 established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that pronouncement permitted entities to continue applying the intrinsic-value-based model of APB 25, provided that the financial statements disclosed the pro forma net income or loss based on the preferable fair-value method. Through December 31, 2005, the Company applied the intrinsic value-based method of accounting prescribed by APB 25 and related interpretations including Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation an interpretation of APB Opinion No. 25* issued in March 2000, to account for its employee stock options and restricted stock grants. Under this method, employee compensation expense was recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

Through December 31, 2005, the Company recognized compensation expense over the vesting period utilizing the accelerated methodology described in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.

In December 2004, the FASB issued SFAS 123R, which replaces SFAS 123 and supersedes APB 25. The Company began applying SFAS 123R as of January 1, 2006, using the modified prospective application method. As a result, the Company s consolidated financial statements reflect an expense for (a) all share-based compensation arrangements granted after January 1, 2006 and for any such arrangements that are modified, cancelled, or repurchased after that date, and (b) the portion of previous share-based awards for which the requisite service has not been rendered as of that date, based on the grant-date estimated fair value of those awards estimated in accordance with the pro forma provisions of SFAS 123. Under the modified prospective application method, our condensed consolidated financial statements for periods prior to the first quarter of 2006 have not been restated. Upon adoption of SFAS 123R, the Company recognized a one-time gain from the cumulative effect of a change in accounting principle, net of tax, of $151,000 based on SFAS 123R s requirement to apply an estimated forfeiture rate to unvested awards. Previously, the Company had recorded forfeitures as incurred.

The Company will recognize stock-based compensation expense after adoption of SFAS 123R using the straight-line method for all stock awards issued after January 1, 2006, which results in the recognition of less stock-based compensation expense over at least the next several years compared to that which would have been recognized had the Company continued to use the accelerated method.

SFAS 123R requires that the deferred stock-based compensation on the Company s balance sheet on the date of adoption be netted against paid-in capital. The Company netted approximately $3.0 million of deferred stock-based compensation against paid-in capital on the balance sheet upon adoption of SFAS 123R.

Prior to adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating inflows in the consolidated statements of cash flows, in accordance with the provisions of the Emerging Task Force (EITF) issue No. 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option.* SFAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. This amount is shown as Excess tax benefit related to stock options on the consolidated statement of cash flows.

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The per share fair value of stock options granted during the three and nine months ended September 30, 2005 and 2006 was determined on the date of grant using the Black Scholes option-pricing model with the following assumptions:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Expected life (in years)	4.0	4.0	4.0	4.0
Risk-free interest rate	3.70%-4.18%	4.60%-5.12%	4.18%	4.60%
Expected volatility	58%-61%	54%-58%	58%	54%
Weighted average expected volatility	60%	57%	58%	54%
Expected dividend yield	0%	0%	0%	0%

For the three and nine months ended September 30, 2005 and 2006, the expected life of each award granted was determined based on historical experience with similar awards, giving consideration to contractual terms, vesting schedules and forfeitures. Expected volatility is based on historical volatility levels of the Company s Class B common stock and the expected volatility of companies in similar industries that have similar vesting and contractual terms. The risk free interest rate is based on the implied yield currently available on U.S. Treasury issues with terms approximately equal to the expected life. Since the Company has never paid any cash dividends on the Company s Class B common stock and does not anticipate paying any material cash dividends in the foreseeable future, the Company has used an expected dividend yield of zero.

Stock option activity during the period indicated is as follows:

	Options available for grant	Number of options outstanding	Weighted average exercise price of options outstanding	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Balance at December 31, 2005	96,009	5,414,932	$ 9.79		
Increase to option pool January 1, 2006	1,972,526				
Granted equal to or above fair value	(1,052,927)	1,052,927	21.06		
Options exercised		(476,051)	3.79		
Options cancelled	668,271	(668,271)	14.03		
Options forfeited	19,677	(19,677)	9.64		
Balance at September 30, 2006	1,703,556	5,303,860	$ 12.03	8.04	$ 44,187,000
Options exercisable at September 30, 2006		1,923,574	$ 6.22	7.10	$ 26,554,000

Information related to stock option activity during the period indicated is as follows:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three Months ended September 30, 2005	Three Months ended September 30, 2006
Weighted average fair value of options granted	$ 8.29	$ 10.24	$ 7.62	$ 7.22
Intrinsic value of options exercised	$ 1,467,000	$ 7,636,000	$ 320,000	$ 693,000
Total fair value of options vested	$ 2,275,000	$ 4,468,000	$ 586,000	$ 1,545,000

At September 30, 2006, there was $13.8 million of stock option compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 1.38 years.

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During the three and nine months ended September 30, 2006, gross proceeds recognized from the exercise of stock options was approximately $250,000 and $1,802,000, respectively. The tax benefit realized from the exercise of options during the three and nine months ended September 30, 2006 was approximately $193,000 and $2,173,000, respectively.

Restricted stock activity for the nine months ended September 30, 2006 is summarized as follows:

	Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2005	265,410	$ 16.95
Granted	192,631	19.13
Vested	(76,671)	16.97
Unvested at September 30, 2006	381,370	$ 18.05

Prior to 2006, the Company had issued restricted stock to employees for future services in connection with acquisitions. Through December 31, 2005, in accordance with the accelerated vesting methodology under FIN 28, the Company amortized the stock-based compensation related to the restricted stock awards as compensation expense over the associated employment periods over which the shares vest. The graded vesting schedules generally range from 2.5 to 3 years. For all awards granted prior to January 1, 2006, the Company will continue amortizing the stock-based compensation related to the unvested stock awards as compensation expense over the associated employment periods over which the shares vest in accordance with the accelerated vesting methodology under FIN 28. The Company issued 192,631 shares of restricted shares to employees for future services in connection with the acquisitions completed in 2006. The restricted shares issued in 2006 will be accounted for under SFAS 123R using the straight-line method net of estimated forfeitures.

As of September 30, 2006, there was $3.8 million of total restricted stock compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 1.17 years. There were no shares of restricted stock vested during the three months ended September 30, 2005 and 2006. The total fair value of restricted stock awards vested during the nine months ended September 30, 2005 and 2006 was $122,000 and $1.3 million, respectively. The Company realized a tax benefit during the three and nine months ended September 30, 2006 related to the vesting of restricted shares of approximately $107,000. In October 2006, the compensation committee of the Company s board of directors resolved to approve effective January 1, 2007 grants to certain executives of 2.3 million shares of restricted Class B common stock which vest over a six year period. Stock-based compensation expense will be recognized over the vesting period when these grants are effected.

The following table summarizes stock-based compensation expense related to all stock-based awards under SFAS 123R:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three Months ended September 30, 2005	Three Months ended September 30, 2006
Stock-based compensation:				
Total stock-based compensation included in net income (loss)	$ 1,202,000	$ 10,154,000	$ 558,000	$ 3,205,000
Income tax benefit related to stock-based compensation included in net income (loss)	$ 277,000	$ 1,361,000	$ 49,000	$ 451,000

In accordance with the methodology described in SFAS 123R, $63,000 and $140,000 of stock-based compensation expense related to stock options was capitalized as part of internally developed software during the three and nine months ended September 30, 2006, respectively.

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The following table presents the impact of our adoption of SFAS 123R on selected line items from our condensed consolidated financial statements for the three and nine months ended September 30, 2006:

	Nine months ended September 30, 2006 As reported under SFAS 123R	Nine months ended September 30, 2006 If reported under APB 25	Three Months ended September 30, 2006 As reported under SFAS 123R	Three Months ended September 30, 2006 If reported under APB 25
Condensed consolidated statement of operations:				
Income (loss) from operations	$ (34,041)	$ 7,040,694	$ 2,790	$ 2,042,598
Income before provision for income taxes	$ 2,273,330	$ 9,348,065	$ 824,053	$ 2,863,861
Income (loss) before cumulative effect of a change in accounting principle	$ (31,917)	$ 6,145,826	$ 11,258	$ 1,810,879
Net income (loss) applicable to common shareholders	$ (2,218,805)	$ 3,807,597	$ (410,889)	$ 1,388,732
Net income (loss) per share applicable to common shareholders				
Basic	$ (0.06)	$ 0.10	$ (0.01)	$ 0.04
Diluted	$ (0.06)	$ 0.10	$ (0.01)	$ 0.03
Condensed consolidated statement of cash flows:				
Net cash provided by operating activities	$ 26,833,818	$ 28,859,169	$ 11,152,292	$ 11,344,943
Net cash provided (used) by financing activities	$ 1,397,863	$ (627,488)	$ 170,381	$ (22,270)

Prior to the adoption of SFAS 123R, the Company followed the intrinsic value method in accordance with APB 25 to account for stock-based compensation. The following table illustrates the effect on net income for the three and nine months ended September 30, 2005, if the fair-value-based method of SFAS 123 had been applied to all outstanding awards in the prior period.

	Nine months ended September 30, 2005	Three months ended September 30, 2005
Net income applicable to common stockholders:		
As reported	$ 522,423	$ 26,537
Add: stock based employee compensation expense included in reported net income, net of related tax effect	924,597	509,270
Deduct: stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effect	(6,914,945)	(2,650,602)
Pro forma net loss applicable to common stockholders	$ (5,467,925)	$ (2,114,795)
Net income (loss) per share applicable to common stockholders:		
As reported basic	$ 0.02	$ 0.00
As reported diluted	$ 0.01	$ 0.00
Pro forma basic	$ (0.16)	$ (0.06)
Pro forma diluted	$ (0.16)	$ (0.06)

(b) Employee Stock Purchase Plan

On February 15, 2004, the Company s board of directors and shareholders approved the 2004 Employee Stock Purchase Plan, which became effective on March 30, 2004. The Company has authorized an aggregate of 300,000 shares of Class B common stock for issuance under the plan

to participating employees.

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The original plan provided eligible employees the opportunity to purchase the Company s Class B common stock for amounts up to 15% of their compensation during offering periods. Under the plan, no employee was permitted to purchase stock worth more than $25,000 in any calendar year, valued as of the first day of each offering period.

The original purchase plan provided for offering periods which were determined by the board of directors. Eligible participants could purchase Class B common stock under the purchase plan at a price equal to the lesser of 85% of the fair value on the first day of an offering period or 85% of the fair value on the last day of an offering period. During 2005, 17,280 shares were purchased at prices ranging from $12.75 to $15.84 per share. As of December 31, 2005, approximately 256,000 shares were available under the purchase plan for future issuance.

In December 2005, the compensation committee of the Company s board of directors amended the 2004 Employee Stock Purchase Plan to provide that effective January 1, 2006 eligible participants may purchase Class B common stock under the purchase plan at a price equal to 95% of the fair value on the last day of an offering period. During the nine months ended September 30, 2006, 3,425 shares were purchased at prices ranging from $14.57 to $18.28 per share. At September 30, 2006, approximately 253,000 shares were available under the purchase plan for future issuance.

(4) Net Income (Loss) Per Share

The Company s basic and diluted net income (loss) per share is presented for the three months ended September 30, 2005 and 2006 and nine months ended September 30, 2005 and 2006. Basic net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the year. Diluted net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common and dilutive common equivalent shares outstanding during the period. Net income (loss) applicable to common stockholders consists of net income (loss) as adjusted for the cumulative effect of change in accounting principle, net of tax and the impact of convertible preferred stock dividends and conversion payment. Diluted net income (loss) per share includes the cumulative effect of change in accounting principle, net of tax and excludes the convertible preferred stock dividends and conversion payment and includes the shares that the preferred stock is convertible into if the result is dilutive. As the Company had a net loss for the three and nine months ended September 30, 2006, basic and diluted net loss per share are the same.

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The following table reconciles the Company s reported net income (loss) to net income (loss) applicable to common stockholders used to compute basic and diluted net income (loss) per share for the three months ended September 30, 2005 and 2006 and the nine months ended September 30, 2005 and 2006:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Numerator:				
Net income (loss) before cumulative effect of change in accounting principle	$ 2,237,042	$ (31,917)	$ 709,350	$ 11,258
Cumulative effect of change in accounting principle, net of taxes		151,341		
Convertible preferred stock dividends	(1,714,619)	(2,338,229)	(682,813)	(422,147)
Net income (loss) applicable to common stockholders	$ 522,423	$ (2,218,805)	$ 26,537	$ (410,889)
Denominator:				
Weighted average common shares outstanding excluding unvested common shares subject to repurchase or cancellation	33,886,928	38,065,347	36,043,092	38,720,191
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	33,886,928	38,065,347	36,043,092	38,720,191
Effect of dilutive securities:				
Weighted average stock options and warrants and common shares subject to repurchase or cancellation	2,301,891		2,101,414	
Weighted average number of shares outstanding use to calculate diluted net income (loss) per share	36,188,819	38,065,347	38,144,506	38,720,191
Basic net income (loss) per share applicable to common stockholders	$ 0.02	$ (0.06)	$ 0.00	$ (0.01)
Diluted net income (loss) per share applicable to common stockholders	$ 0.01	$ (0.06)	$ 0.00	$ (0.01)

The computation of diluted net income (loss) per share excludes the following because their effect would be anti-dilutive:

For the three and nine months ended September 30, 2005 and for the three and nine months ended September 30, 2006, 2,346,939 shares and 1,450,377 shares, respectively, issuable upon conversion of the 4.75% convertible preferred stock issued in connection with the February 2005 follow-on public offering.

For the three and nine months ended September 30, 2005, outstanding options to acquire 889,400 and 608,300 shares of Class B common stock with a weighted average exercise price of $18.00 per share and $18.78 per share, respectively, and for the three months and nine months ended September 30, 2006, outstanding options to acquire 5,303,860 shares of Class B common stock with a weighted average exercise price of $12.03 per share.

For the three and nine months ended September 30, 2006, warrants to acquire 6,500 shares of Class B common stock at an exercise price of $8.45.

For the three and nine months ended September 30, 2006, 381,370 shares of unvested Class B restricted common shares at September 30, 2006 issued to employees in connection with acquisitions. These shares were for future services that vest over periods ranging from two and one-half to three years. Unvested shares were excluded from the computation of basic net income (loss) per share.

(5) Concentrations
The Company maintains substantially all of their cash and cash equivalents with one financial institution.

A substantial majority of the Company s revenue earned from merchant advertisers is generated through arrangements with distribution partners. The Company may not be successful in renewing any of these agreements, or if they are renewed, they may not be on terms as favorable as current agreements. The Company may not be successful in entering into agreements with new distribution partners on commercially acceptable terms. In addition, several of these distribution partners may be considered potential competitors.

The percentage of revenue earned from merchant advertisers supplied by distribution partners representing more than 10% of consolidated revenue is as follows:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Distribution Partner A	11%	7%	10%	6%

Distribution Partner A was a new merchant advertiser in 2005 who represented approximately 23% and 28% of revenue for the three months ended September 30, 2005 and 2006, and approximately 21% and 27% of revenue for the nine months ended September 30, 2005 and 2006, respectively. This same merchant advertiser represented approximately 37% and 44% of the outstanding accounts receivable balance at December 31, 2005 and September 30, 2006, respectively.

(6) Segment Reporting and Geographic Information
Operating segments are revenue-producing components of the enterprise for which separate financial information is produced internally for the Company s management. For all periods presented the Company operated as a single segment. The Company operates in a single operating segment principally in domestic markets providing Internet merchant transaction services to enterprises.

Revenues from merchant advertisers by geographical areas are tracked on the basis of the location of the merchant advertiser. The vast majority of the Company s revenue and accounts receivable are derived from domestic sales to advertisers engaged in various activities involving the Internet.

Revenues by geographic region are as follows (in percentages):

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
United States	90%	91%	91%	89%
Canada	3%	2%	2%	2%
Other countries	7%	7%	7%	9%
	100%	100%	100%	100%

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(7) Property and Equipment

Property and equipment consisted of the following:

	As of December 31, 2005	As of September 30, 2006 (unaudited)
Computer and other related equipment	$ 2,828,726	$ 4,124,759
Purchased and internally developed software	2,142,710	5,832,149
Furniture and fixtures	107,829	280,719
Leasehold improvements	94,561	128,512
	$ 5,173,826	$ 10,366,139
Less accumulated depreciation and amortization	(1,771,564)	(3,034,280)
Property and equipment, net	$ 3,402,262	$ 7,331,859

The Company has capitalized certain costs of internally developed software for internal use. The estimated useful life of costs capitalized is evaluated for each specific project. Amortization begins in the period in which the software is ready for its intended use. The Company had $1.3 million and $1.6 million of internally developed software costs that had not commenced amortization as of December 31, 2005 and September 30, 2006, respectively.

(8) Commitments

The Company has commitments for future payments related to office facilities leases, equipment and furniture leases, and other contractual obligations. The Company leases its office facilities under operating lease agreements expiring through 2010. The equipment and furniture leases are financed through capital lease arrangements and are included in property and equipment and the related depreciation is recorded as depreciation expense. The Company also has other contractual obligations expiring over varying time periods through 2009. Other contractual obligations primarily relate to minimum contractual payments due to distribution partners and other service providers. Future minimum payments are as follows:

	Equipment and furniture capital leases	Facilities operating leases	Other contractual obligations	Total
2006	$ 5,135	$ 293,225	$ 604,856	$ 903,216
2007	20,539	976,494	576,782	1,573,815
2008	20,539	758,018	130,168	908,725
2009	17,851	629,259	82,598	729,708
2010		169,294		169,294
Total minimum payments	$ 64,064	$ 2,826,290	$ 1,394,404	$ 4,284,758
Less: amounts representing interest	(13,004)			
Present value of lease obligation	51,060			
Less current portion	(13,889)			
Long-term portion	$ 37,171			

Rent expense incurred by the Company was approximately $254,000 and $257,000 for the three months ended September 30, 2005 and 2006, respectively, and $599,000 and $774,000 for the nine months ended September 30, 2005 and 2006.

In October 2006, the Company entered into a lease agreement for additional office space in Seattle, Washington commencing in 2007 and expiring in 2009 totaling approximately $1.4 million. This amount is not included in the above table.

In connection with the closing of the Name Development asset acquisition in 2005, the Company entered into (i) a new master agreement with an advertising partner with respect to the Company s direct navigation business, and (ii) a license agreement with the same partner with respect to certain of the partner s patents, pursuant to which the Company paid $4.5 million in an upfront payment (and an additional $674,000 in certain circumstances) and a contingent royalty based upon a discounted rate of 3% (3.75% under certain circumstances) of certain of the Company s gross revenues payable on a quarterly basis through December 2016. The royalty payment is recognized as incurred in service costs.

(9) Contingencies and Taxes

(a) Contingencies

The Company is involved in legal and administrative proceedings and claims of various types from time to time. While any litigation contains an element of uncertainty, the Company is not aware of any legal proceedings or claims which are pending that the Company believes, based on current knowledge, will have, individually or taken together, a material adverse effect on the Company s financial condition or results of operations.

(b) Taxes

From time to time, various state, federal and other jurisdictional tax authorities undertake reviews of the Company and its filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for probable exposures. The Company believes any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

(10) Name Development Asset Acquisition

On February 14, 2005, the Company acquired substantially all of the assets of Name Development**,** a corporation operating in the direct navigation market, for purchase price consideration of $164.4 million in a combination of cash and equity. The Company accounted for the Name Development asset acquisition as a business combination. Under the terms of the agreement, the Company acquired certain assets of Name Development, including its portfolio of Internet domains and Web sites, revenue-generating contracts, technology and systems for the operation of the Name Development direct navigation business. The Company did not assume any other obligations with respect to Name Development as part of this asset acquisition. As a result of the acquisition, the Company obtained a proprietary source of targeted traffic.

The following summarizes the estimated fair value of the assets acquired at the date of acquisition:

Current assets	$ 45,808
Intangible assets	52,948,941
Goodwill	111,061,747
Total assets acquired	$ 164,056,496

In connection with the acquisition, $24.6 million of the cash consideration was placed in escrow to secure indemnification obligations for a period of 18 months from the closing date. The escrow amounts are included as part of the purchase price consideration. The escrow agent is holding the balance of the escrow amount pending a determination related to potential indemnification obligations. In the event any indemnification obligations are so determined, the purchase price will be reduced accordingly. A net amount of $357,000 was released from escrow in March 2006 in satisfaction of certain intangible asset indemnification obligations. This amount was reflected as an adjustment to goodwill.

The acquired intangible assets in the amount of $52.9 million have a weighted average useful life of approximately 4.4 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of a non-compete agreement with a value of approximately $5.7 million (2-year weighted-average

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useful life), domain names with a value of approximately $46.4 million (4.7-year weighted average useful life), and acquired technology with a value of approximately $800,000 (3-year weighted average useful life). The goodwill of $111.1 million and the acquired intangible assets with a value of $52.9 million are deductible over 15 years for federal tax purposes.

(11) Pike Street Industries Asset Acquisition

On April 26, 2005, the Company acquired certain assets of Pike Street, an online yellow pages and lead generation provider for local merchants. The purchase price consideration consisted of:

- $12.8 million in cash and estimated acquisition costs; plus
- 242,748 shares of Class B common stock; plus
- 212,404 shares of restricted Class B common stock that vest over a period of 3 years.

The Company accounted for the Pike Street asset acquisition as a business combination and as a result of the acquisition, acquired additional sources of proprietary targeted traffic.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $4.1 million. The shares of restricted Class B common stock were valued at $16.85 per share (the last reported sales price on the closing date) for an aggregate amount of approximately $3.6 million. The shares of restricted Class B common stock were issued to the former stockholders of Pike Street who became employees of the Company. The shares vest over a period of three years from the closing date, with the first 16.67% vesting after six months and each additional 16.67% vesting each successive 6-month period over the next thirty months. As part of employment agreements entered into with these former stockholders of Pike Street, a deferred stock-based compensation charge of approximately $3.6 million was recorded in connection with the 212,404 shares of restricted Class B common stock. The deferred stock-based compensation, net of forfeitures, is being amortized using the accelerated vesting method as compensation costs over the associated three-year employment periods over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

The Company did not assume any other obligations with respect to Pike Street as part of this asset acquisition.

The following summarizes the estimated fair value of the assets acquired at the date of acquisition:

Property and equipment	$ 6,874
Intangible assets	5,025,000
Goodwill	11,827,967
Total assets acquired	$ 16,859,841

In connection with the acquisition, $1.3 million of the cash consideration, 24,275 shares of Class B common stock, and 81,927 shares of restricted Class B common stock were placed in escrow to secure indemnification obligations for a period of 12 months from the closing date. The escrow amounts have been included as part of the purchase price consideration and were released upon termination of the escrow period.

The acquired intangible assets in the amount of $5.0 million have a weighted average useful life of approximately 3.4 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of non-compete agreements with a value of approximately $500,000 (3-year weighted-average useful life), domain names with a value of approximately $1.0 million (5-year weighted average useful life), merchant advertiser customer base with a value of approximately $2.4 million (3-year weighted-average useful

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life) and acquired technology with a value of approximately $1.1 million (3-year weighted average useful life). The goodwill of $11.8 million and the acquired intangible assets with a value of $5.0 million are deductible over 15 years for federal tax purposes.

(12) IndustryBrains Acquisition

On July 27, 2005, the Company acquired IndustryBrains, a company focused on monetizing Web sites through contextual advertising solutions, for the following purchase price consideration:

$16.1 million in net cash and estimated acquisition costs; plus

788,046 shares of Class B common stock; plus

176,909 shares of restricted Class B common stock that vest over a period of two and one-half years.

The Company accounted for the IndustryBrains acquisition as a business combination. As a result of the acquisition, the Company obtained technologies focused on contextual advertising solutions and a broader base of merchant advertisers and distribution partners.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $13.4 million.

The shares of restricted Class B common stock were valued at $17.00 per share (the last reported sales price on the closing date) for an aggregate amount of approximately $3.0 million. The shares of restricted Class B common stock were issued to employee stockholders of IndustryBrains who became employees of the Company. The shares vest over a period of two and one-half years from the closing date, with the first 33.34% vesting after ten months and each additional 33.33% vesting each successive ten month period over the next twenty months. As part of employment agreements entered into with these former stockholders of IndustryBrains, a deferred stock-based compensation charge of approximately $3.0 million was recorded in connection with the 176,909 shares of restricted Class B common stock. The deferred stock-based compensation, net of estimated forfeitures, is being amortized using the accelerated vesting method as compensation costs over the associated three-year employment periods over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

The following summarizes the estimated fair value of the assets acquired and the liabilities assumed at the date of acquisition:

Current assets, including acquired cash and cash equivalents of $1,147,154	$ 2,074,787
Property and equipment	81,008
Other non-current assets	55,805
Intangible assets	8,100,000
Goodwill	25,018,206
Total assets acquired	35,329,806
Current liabilities	1,718,714
Non-current deferred tax liabilities	2,957,799
Total liabilities assumed	4,676,513
Net assets acquired	$ 30,653,293

In connection with the acquisition, $2.5 million of the cash consideration, 118,207 shares of Class B common stock, and 26,536 shares of restricted Class B common stock were placed in escrow to secure indemnification obligations for a period of 12 months from the closing date. The escrow amounts have been included as part of the purchase price consideration and were released upon termination of the escrow period.

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The acquired estimated intangible assets in the amount of $8.1 million have a weighted average useful life of approximately 2.8 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of non-compete agreements with a value of approximately $900,000 (2-year weighted-average useful life), domain names with a value of approximately $400,000 (1.5-year weighted average useful life), merchant advertiser customer base with a value of approximately $3.1 million (3-year weighted-average useful life), distribution partner base of approximately $900,000 (3-year weighted-average useful life), and acquired technology with a value of approximately $2.8 million (3-year weighted average useful life). The goodwill of $25.0 million and the acquired intangible assets with a value of $8.1 million are not deductible for federal tax purposes.

(13) AreaConnect Asset Acquisition

On May 1, 2006, the Company acquired certain assets of AreaConnect, a provider of local online traffic to Yellow and White Pages publishers. The purchase price consideration consisted of:

- $12.2 million in cash and estimated acquisition costs; plus
- 183,832 shares of Class B common stock; plus
- 78,129 shares of restricted Class B common stock that vest over a period of 3 years.

The Company accounted for the AreaConnect asset acquisition as a business combination and as a result of the acquisition, acquired additional sources of proprietary targeted traffic.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $3.9 million. The shares of restricted Class B common stock were valued at $21.39 per share (the last reported sales price on the closing date) for an aggregate amount of approximately $1.7 million. The shares of restricted Class B common stock were issued to the former equityholder of AreaConnect who became an employee of the Company. The shares vest over a period of three years from the closing date, with the first 16.67% vesting after six months and each additional 16.67% vesting each successive 6-month period over the next thirty months. As part of the employment agreement entered into with the former equityholder of AreaConnect, a deferred stock-based compensation charge of approximately $1.7 million was recorded in connection with the 78,129 shares of restricted Class B common stock. The deferred stock-based compensation, net of estimated forfeitures, is being amortized on a straight-line basis as compensation costs over the associated three-year employment period over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

The Company did not assume any other obligations with respect to AreaConnect as part of this asset acquisition.

The following summarizes the preliminary estimated fair value of the assets acquired at the date of acquisition:

Intangible assets	$ 3,520,000
Goodwill	12,652,666
Total assets acquired	$ 16,172,666

To date the Company has conducted a preliminary analysis of the estimated fair value of the assets acquired from AreaConnect. The foregoing estimates may be subject to adjustment upon the completion of the Company s final review and assessment of the fair value of the intangible assets included in the acquisition.

In connection with the acquisition, $1.2 million of the cash consideration, 55,609 shares of Class B common stock, and 11,719 shares of restricted Class B common stock were placed in escrow to secure indemnification obligations for a period of 12 months from the closing date.

The escrow amounts are included as part of the

purchase price consideration. In the event any indemnification obligations are identified, the purchase price will be reduced accordingly. The escrow amounts, less any indemnification obligations identified, will be released upon termination of the escrow period.

The acquired intangible assets in the amount of $3.5 million have a weighted average useful life of approximately 2.6 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of a non-compete agreement with a value of approximately $400,000 (3-year weighted-average useful life), domain names with a value of approximately $20,000 (3-year weighted average useful life), merchant advertiser customer base with a value of approximately $1.0 million (1.5-year weighted-average useful life) and acquired technology with a value of approximately $2.1 million (3-year weighted average useful life). The goodwill of $12.7 million and the acquired intangible assets with a value of $3.5 million are deductible over 15 years for federal tax purposes.

(14) Open List Asset Acquisition

On May 26, 2006, the Company acquired certain assets of Open List, including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform. The purchase price consideration consisted of:

- $6.3 million in cash and estimated acquisition costs; plus

- 286,254 shares of Class B common stock; plus

- 114,502 shares of restricted Class B common stock that vest over a period of two and one-half years.

The Company accounted for the Open List asset acquisition as a business combination and as a result of the acquisition, acquired additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $5.0 million. The shares of restricted Class B common stock were valued at $17.58 per share (the last reported sales price on the closing date) for an aggregate amount of approximately $2.0 million. The shares of restricted Class B common stock were issued to certain former equityholders of Open List who became employees of the Company. The shares vest over a period of two and one-half years from the closing date, with the first 20.0% vesting after six months and each additional 20.0% vesting each successive 6-month period over the next twenty-four months. As part of the employment agreements entered into with certain former equityholders of Open List, a deferred stock-based compensation charge of approximately $2.0 million was recorded in connection with the 114,502 shares of restricted Class B common stock. The deferred stock-based compensation, net of estimated forfeitures, is being amortized on a straight-line basis as compensation costs over the associated two and one-half year employment periods over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

The Company did not assume any other obligations with respect to Open List as part of this asset acquisition.

The following summarizes the preliminary estimated fair value of the assets acquired at the date of acquisition:

Property and equipment	$ 10,000
Intangible assets	3,520,000
Goodwill	7,829,845
Total assets acquired	$ 11,359,845

To date the Company has conducted a preliminary analysis of the estimated fair value of the assets acquired from Open List. The foregoing estimates may be subject to adjustment upon the completion of the Company s final review and assessment of the fair value of the assets included in the acquisition.

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In connection with the acquisition, $600,000 of the cash consideration and 40,076 shares of Class B common stock were placed in escrow to secure indemnification obligations for a period of 12 months from the closing date. The escrow amounts are included as part of the purchase price consideration. In the event any indemnification obligations are identified, the purchase price will be reduced accordingly. The escrow amounts, less any indemnification obligations identified, will be released upon termination of the escrow period.

The acquired intangible assets in the amount of $3.5 million have a weighted average useful life of approximately 3.1 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of non-compete agreements with a value of approximately $400,000 (2-year weighted-average useful life), domain names with a value of approximately $20,000 (3-year weighted average useful life), merchant advertiser customer base with a value of approximately $900,000 (2.5-year weighted-average useful life) and acquired technology with a value of approximately $2.2 million (3.5-year weighted average useful life). The goodwill of $7.8 million and the acquired intangible assets with a value of $3.5 million are deductible over 15 years for federal tax purposes.

(15) Pro Forma Results of Operations Name Development, Pike Street, IndustryBrains, AreaConnect and Open List (Unaudited)

The following table presents pro forma results of operations for the three and nine months ended September 30, 2006 as if the AreaConnect and Open List asset acquisitions occurred as of January 1, 2006. The pro forma results of operations for the three months ended September 30, 2006 combine: (1) the historical results of operations of the Company for the three months ended September 30, 2006; and (2) the pro forma effect of shares issued in connection with the AreaConnect and Open List asset acquisitions. The pro forma results of operations for the nine months ended September 30, 2006 combine: (1) the historical results of operations of the Company for the nine months ended September 30, 2006; (2) AreaConnect s historical results of operations for the pre-acquisition period from January 1, 2006 to April 30, 2006; and (3) Open List s historical results of operations for the pre-acquisition period from January 1, 2006 to May 25, 2006. The following table presents pro forma results of operations for the three and nine months ended September 30, 2005 as if the IndustryBrains acquisition and the Name Development, Pike Street, AreaConnect and Open List asset acquisitions occurred as of January 1, 2005. The pro forma results of operations for the three months ended September 30, 2005 combine: (1) the historical results of operations of the Company for the three months ended September 30, 2005; (2) IndustryBrains historical results of operations for the pre-acquisition period from July 1, 2005 to July 26, 2005; and (3) AreaConnect s and Open List s pre-acquisition historical results of operations for the three months ended September 30, 2005. The pro forma results of operations for the nine months ended September 30, 2005 combine: (1) the historical results of operations of the Company for the nine months ended September 30, 2005; (2) Name Development s historical results of operations for the pre-acquisition period from January 1, 2005 to February 13, 2005; (3) an offering of only that number of shares of Class B common stock and preferred stock as necessary to consummate the Name Development asset acquisition for the period January 1, 2005 through February 13, 2005; (4) Pike Street s historical results of operations for the pre-acquisition period from January 1, 2005 to April 25, 2005; and (5) IndustryBrains historical results of operations for the pre-acquisition period from January 1, 2005 to July 26, 2005; and (6) AreaConnect s and Open List s pre-acquisition historical results of operations for the nine months ended September 30, 2005. A forfeiture by an employee of restricted stock related to the Pike Street acquisition occurred in the three months ended September 30, 2005 resulted in a pro forma reversing adjustment in the three and nine months ended September 30, 2005. The Company has used statutory rates in effect during the three and nine months ended September 30, 2005 and 2006 to calculate the tax effects of the pro forma adjustments in determining the pro forma results of operations for each of the periods presented.

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	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Revenue	$ 76,071,045	$ 95,937,088	$ 26,766,190	$ 32,326,116
Net income (loss)	(2,047,110)	(1,342,759)	(135,975)	11,258
Net loss applicable to common stockholders	(4,058,604)	(3,680,988)	(818,788)	(410,889)
Net loss per share applicable to common stockholders:				
Basic and diluted net loss per share	$ (0.11)	$ (0.10)	$ (0.02)	$ (0.01)

The pro forma information is not necessarily indicative of the combined results that would have occurred had the acquisitions taken place at January 1, 2005 or at January 1, 2006, nor is it necessarily indicative of results that may occur in the future.

(16) Intangible Assets from Acquisitions

Intangible assets from acquisitions consist of the following:

	As of December 31, 2005	As of September 30, 2006 (unaudited)
Merchant advertiser customer base	$ 7,000,000	$ 8,900,000
Distribution partner base	3,100,000	3,100,000
Non-compete agreements	9,100,000	9,900,000
Trademarks/domains	46,979,732	45,604,885
Acquired technology	11,400,000	15,700,000
	$ 77,579,732	$ 83,204,885
Less accumulated amortization	(26,232,788)	(41,077,644)
Total	$ 51,346,944	$ 42,127,241

Amortizable intangible assets are amortized on a straight-line basis over their useful lives. Aggregate amortization expense incurred by the Company was approximately $5.2 million and $5.3 million for the three months ended September 30, 2005 and 2006, respectively, and approximately $13.2 million and $15.3 million for the nine months ended September 30, 2005 and 2006, respectively. Based upon the current amount of intangible assets subject to amortization, the estimated amortization expense for the next five years is as follows: $5.1 million for the remainder of 2006, $16.5 million in 2007, $12.3 million in 2008, $4.2 million in 2009, and $4.0 million in 2010 and thereafter.

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(17) Intangible and other assets, net
Intangible and other assets, net consisted of the following:

	As of December 31, 2005	As of September 30, 2006 (unaudited)
Internet domain names	$ 13,407,166	$ 13,935,989
Less accumulated amortization	(2,327,978)	(4,356,638)
Other intangible assets, net	11,079,188	9,579,351
Other assets:		
License fee	4,500,000	4,500,000
Less accumulated amortization	(1,128,826)	(2,093,112)
License fee, net	3,371,174	2,406,888
Restricted cash	800,000	800,000
Other	197,142	197,764
Total intangibles and other assets, net	$ 15,447,504	$ 12,984,004

The Company capitalizes costs incurred to acquire domain names or URLs, which include the initial registration fees, to other intangible assets which excludes intangible assets acquired through business combinations. The capitalized costs are amortized over the expected useful life of the domain names on a straight-line basis. Based upon the current amount of domains subject to amortization, the estimated expense for the next five years is as follows: $691,000 for the remainder of 2006, $2.7 million in 2007, $2.2 million in 2008, $1.6 million in 2009, and $2.4 million in 2010 and thereafter. There were domains held for sale valued at approximately $300,000 and $5,500 under prepaid expenses and other current assets as of December 31, 2005 and September 30, 2006, respectively, which are no longer being amortized.

In 2005, the Company entered into a license agreement with an advertising partner with respect to certain of the partner s patents, pursuant to which the Company paid $4.5 million in an upfront payment (and an additional $674,000 in certain circumstances) and a contingent royalty based upon a discounted rate of 3% (3.75% under certain circumstances) of certain of the Company s gross revenues payable on a quarterly basis through December 2016. The upfront license fee was capitalized and is being amortized ratably over 42 months.

(18) Convertible Preferred Stock Dividends
In March 2006, the Company entered into privately negotiated and unsolicited transactions with certain holders of the preferred stock in which such holders converted approximately 80,848 shares of the Company s preferred stock into approximately 824,980 shares of the Company s Class B common stock at a conversion rate of $24.50 per share and received a cash payment from the Company of $12.00 per share of preferred stock for an aggregate amount of approximately $970,000 in order to induce conversions. The $970,000 was reflected as preferred stock dividends and conversion payment in the Company s financial statements. Approximately 142,137 shares of preferred stock remain outstanding as of September 30, 2006.

In April 2006, the Company s board of directors declared a quarterly dividend in the amount of $2.97 per share on its 4.75% convertible exchangeable preferred stock which was paid on May 15, 2006 to the holders of record as of the close of business on May 4, 2006. This quarterly dividend obligation totaled approximately $422,000.

In July 2006, the Company s board of directors declared a quarterly dividend in the amount of $2.97 per share on its 4.75% convertible exchangeable preferred stock which will be paid on August 15, 2006 to the holders of record as of the close of business on August 4, 2006. This quarterly dividend obligation totaled approximately $422,000.

In October 2006, the Company s board of directors declared a quarterly dividend in the amount of $2.97 per share on its 4.75% convertible exchangeable preferred stock which will be paid on November 15, 2006 to the holders of record as of the close of business on November 4, 2006. This quarterly dividend obligation totals approximately $422,000.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use words such as believes , intends , expects , anticipates , plans , may , will and similar expressions to identify forward-looking statements. All forward-looking statements, including, but not limited to, statements regarding our future operating results, financial position, and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are inherently uncertain as they are based on our expectations and assumptions concerning future events. Any or all of our forward-looking statements in this report may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including but not limited to the risks, uncertainties and assumptions described in this report, in Part II, Item 1A. Risk Factors and elsewhere in our Annual Report on Form 10-KSB for the year ended December 31, 2005 and in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and those described from time to time in our future reports filed with the Securities and Exchange Commission. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements. All forward-looking statements in this report are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.

The following discussion and analysis provides information that we believe is relevant to an assessment and understanding of our results of operation and financial condition. You should read this analysis in conjunction with the attached condensed consolidated financial statements and related notes thereto, and with our audited consolidated financial statements and the notes thereto, included in our Annual Report on Form 10-KSB for the year ended December 31, 2005.

Overview

We are a technology driven search and media company focused on vertical and local online traffic. Specifically, we are focused on direct navigation, local search and search marketing. Our network of vertical and local Web sites provide online users with: (1) information relating to specific products or services; and (2) relevant advertisers who sell such products or services. Our platform of search marketing services enables merchants to efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and selected Web sites.

We currently provide consumers and merchant advertisers with the following technology-based services:

Local and Vertical Web Sites. We have more than 200,000 vertical and local Web sites. Our Web sites are designed to help online users find information for specific products or services, and also find relevant advertisers who sell such products or services. We refer to this as direct navigation.

Contextual Targeting. We sell advertising placement on specialized vertical and branded Web sites and on specific sections of a Web site on a bid-for-click basis. We refer to this as site-specific contextual advertising. We believe this site-specific approach to contextual advertising allows publishers an opportunity to monetize the value of their own brand and traffic, and gives advertisers greater transparency and relevancy.

Pay-Per-Click Targeting. We deliver pay-per-click advertising listings that are reflective of our merchant advertisers products and services to online users in response to their keyword search queries, and in response to their typing of specific Web sites into their browser (direct navigation). These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers

and businesses through our distribution network of search engines, product shopping engines, directories and other Web sites. We also generate revenue from cost-per-action services. Cost-per-action revenue occurs when the online user is redirected from the Company web sites to a merchant advertiser web site and completes a specified action.

Natural Search Engine Optimization. We optimize merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.

Outsourced Search Marketing Platforms. We support online marketing efforts of local businesses and SMEs (small and medium-sized enterprises) by providing super-aggregator partners, such as yellow page publishers and newspaper companies, with an outsourced platform of our performance-based advertising and search marketing technology services. Our outsourced platform allows super-aggregator partners to directly sell search marketing packages to their customers, such as yellow page or classified advertisers. Our outsourced platform for publishers, which is separate and distinct from the local platform, allows publishers to monetize their Web site(s) with their advertiser relationships. Our outsourced platforms are provided to super-aggregator partners and publishers allowing the partners and publishers to sell under their brand.

Feed Management. We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. Our trusted feed relationships with certain of our distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web s largest search engines, product shopping engines and directories.

Bid Management. We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date. We have completed the following acquisitions since our inception:

On February 28, 2003, we acquired eFamily together with its direct wholly-owned subsidiary Enhance Interactive. eFamily was incorporated in Utah on November 29, 1999 under the name FocusFilter.com, Inc.

On October 24, 2003, we acquired TrafficLeader which was incorporated in Oregon on January 24, 2000 under the name Sitewise Marketing, Inc.

On July 27, 2004, we acquired goClick which was incorporated in Connecticut on October 25, 2000.

On February 14, 2005, we acquired certain assets of Name Development which was incorporated in the British Virgin Islands in July 2000.

On April 26, 2005, we acquired certain assets of Pike Street Industries, which was incorporated in Washington on March 6, 2002.

On July 27, 2005, we acquired IndustryBrains, which was incorporated in New York on January 31, 2002.

On May 1, 2006, we acquired certain assets of AreaConnect, which was formed in Delaware on June 5, 2002.

On May 26, 2006, we acquired certain assets of Open List, which was incorporated in Delaware on November 18, 2003.
We currently have offices in Seattle, Washington; Orem, Utah; Eugene, Oregon; Las Vegas, Nevada; and New York, New York.

Acquisitions

We have completed the following acquisitions during 2005 and 2006 which have been accounted for as business combinations.

Name Development

In February 2005, we acquired substantially all of the assets of Name Development, a corporation operating in the direct navigation market, for the following consideration:

- $155.6 million in cash and estimated acquisition costs; plus
- 419,659 shares of Class B common stock.

The shares of Class B common stock were valued (for accounting purposes) at an aggregate amount of approximately $8.8 million.

Under the terms of the agreement, we acquired certain assets of Name Development, including its portfolio of Internet domains and Web sites, revenue-generating contracts, technology and systems for the operation of the Name Development direct navigation business. We did not assume any other obligations with respect to Name Development as part of this asset acquisition.

Pike Street Industries

In April 2005, we acquired certain assets of Pike Street, an online yellow pages and lead generation provider for local merchants, for the following consideration:

- $12.8 million in cash and estimated acquisition costs; plus
- 242,748 shares of Class B common stock; plus
- 212,404 shares of restricted Class B common stock which will vest over a three year period from the closing date in installments of 16.67% after each six month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $4.1 million.

We did not assume any other obligations with respect to Pike Street as part of this asset acquisition.

The shares of restricted Class B common stock were issued to employees of Pike Street and valued at approximately $3.6 million, which is recorded as compensation expense over the associated employment period during which these shares vest.

IndustryBrains

In July 2005, we acquired IndustryBrains, a company focused on monetizing Web sites through contextual advertising solutions, for the following consideration:

- $16.1 million in net cash and estimated acquisition costs; plus

788,046 shares of Class B common stock; plus

176,909 shares of restricted Class B common stock issued which will vest over a two and one half year period from the closing date in installments of 33.34% after each ten month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $13.4 million.

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The shares of restricted Class B common stock were issued to employee shareholders of IndustryBrains and valued at approximately $3.0 million, which is recorded as compensation expense over the associated employment period during which these shares vest.

AreaConnect

In May 2006, we acquired certain assets of AreaConnect, a provider of local online traffic to Yellow and White Pages publishers, for the following consideration:

- $12.2 million in cash and estimated acquisition costs; plus
- 183,832 shares of Class B common stock; plus
- 78,129 shares of restricted Class B common stock issued which will vest over a three year period from the closing date in installments of 16.67% after each six month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock were valued (for accounting purposes) at an aggregate amount of approximately $3.9 million.

We did not assume any other obligations with respect to AreaConnect as part of this asset acquisition.

The shares of restricted Class B common stock were issued to the former equityholder of AreaConnect who became an employee of the Company and were valued at approximately $1.7 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

Open List

In May 2006, we acquired certain assets of Open List, including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform, for the following consideration:

- $6.3 million in cash and estimated acquisition costs; plus
- 286,254 shares of Class B common stock; plus
- 114,502 shares of restricted Class B common stock issued which will vest over a two and one-half year period from the closing date in installments of 20% after each six month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock were valued (for accounting purposes) at an aggregate amount of approximately $5.0 million.

We did not assume any other obligations with respect to Open List as part of this asset acquisition.

The shares of restricted Class B common stock were issued to certain former equityholders of Open List who became employees of the Company and were valued at approximately $2.0 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

Consolidated Statements of Operations

The assets, liabilities and operations of our acquisitions are included in our consolidated financial statements as of the date of the respective acquisitions.

All significant inter-company transactions and balances within Marchex have been eliminated in consolidation. Our purchase accounting resulted in all assets and liabilities from our acquisitions being recorded at their estimated fair values on the respective acquisition dates. All goodwill, intangible assets and liabilities resulting from the acquisitions have been recorded in our financial statements.

Presentation of Financial Reporting Periods

The comparative periods presented are for the three months ended September 30, 2005 and 2006 and the nine months ended September 30, 2005 and 2006.

Revenue

We currently generate revenue through our suite of services, including our pay-per-click targeting, feed management, bid management, contextual targeting, natural search optimization and outsourced search marketing services platforms.

Our primary sources of revenue are the performance-based advertising services, which include pay-per-click services, cost-per-action services and feed management services. These primary sources amounted to greater than 92% of our revenues in all periods presented. Our secondary sources of revenue are our bid management services, natural search optimization services and outsourced search marketing platforms. These secondary sources amounted to less than 8% of our revenues in all periods presented. We have no barter transactions.

We recognize revenue upon the completion of our performance obligation, provided that: (1) evidence of an arrangement exists; (2) the arrangement fee is fixed and determinable; and (3) collection is reasonably assured.

In certain cases, we record revenue based on available and reported preliminary information from third parties. Collection on the related receivables may vary from reported information based upon third party refinement of the estimated and reported amounts owing that occurs subsequent to period ends.

Performance-Based Advertising Services

In providing pay-per-click advertising services, we generate revenue upon our delivery of qualified and reported click-throughs to our merchant advertisers or advertising service providers listings. These merchant advertisers and advertising service providers pay us a designated transaction fee for each click-through, which occurs when an online user clicks on any of their advertisement listings after it has been placed by us or by our distribution partners. Each click-through on an advertisement listing represents a completed transaction. The advertisement listings are displayed within our distribution network, which includes search engines, directories, destination sites, Internet domains or Web sites, and other targeted Web-based content. We also generate revenue from cost-per-action services, which occurs when the online user is redirected from the company Web sites to a merchant advertiser Web site and completes the specified action.

In providing contextual targeting services, merchant advertisers purchase keywords or keyword strings, based on an amount they choose for a targeted placement on vertically-focused Web sites or specific pages of a Web site that are specific to their products or services and their marketing objectives. The contextual results distributed by our services are prioritized for users by the amount the merchant advertiser is willing to pay each time a user clicks on the merchant s advertisement and the relevance of the merchant s advertisement, which is dictated by historical click-through rates. Merchant advertisers pay us when a click-through occurs on their advertisement.

In providing feed management services, merchant advertisers pay for their Web pages and product databases to be crawled, or searched, and included in search engine, directory and product shopping engine results within our distribution network. Generally, the feed management listings are presented in a different section of the Web page than the pay-per-click listings. For this service, revenue is generated when an online user clicks on a feed management listing from search engine, directory or product shopping engine results. Each click-through on an advertisement listing represents a completed transaction for which the merchant advertiser pays on a per-click basis. The placement of a feed management result is largely determined by its relevancy, as determined by the distribution partner.

Search Marketing Services

Merchant advertisers pay us additional fees for services such as bid management and natural search engine optimization. Merchant advertisers generally pay us on a click-through basis, although in certain cases we receive a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select merchant advertisers. We may also charge initial set-up, account or inclusion fees as part of our services.

Banner advertising revenue may be based on a fixed fee per click and is generated and recognized on click-through activity. In other cases, banner payment terms are volume-based with revenue generated and recognized when impressions are delivered.

Non-refundable account set-up fees are paid by merchant advertisers and are recognized ratably over the longer of the term of the contract or the average expected merchant advertiser relationship period, which generally ranges from twelve months to more than two years. Other account and service fees are recognized in the month or period the account fee or services relate to.

Other inclusion fees are generally associated with monthly or annual subscription-based services where a merchant advertiser pays a fixed amount to be included in our index of listings or our distribution partners indexes of listings. Revenues from these subscription arrangements are recognized ratably over the service period.

Outsourced Search Marketing Platforms

We generate revenue from super-aggregator partners and publishers utilizing our web-based technologies. We are paid a management or agency fee based on the total amount of the purchase made by the merchant advertiser. The partners or publishers engage the merchant advertisers and are the primary obligor, and we, in certain instances, are only financially liable to the publishers in our capacity as a collection agency for the amount collected from the merchant advertisers. We recognize revenue for these fees under the net revenue recognition method.

Industry and Market Factors

We enter into agreements with various distribution partners to provide distribution for the URL strings and advertisement listings of our merchant advertisers. We generally pay distribution partners based on a percentage of revenue or a fixed amount per click-through on these listings. The level of click-throughs contributed by our distribution partners has varied, and we expect it will continue to vary, from quarter-to-quarter and year-to-year, sometimes significantly. Our current growth will be impacted by our ability to increase our distribution, which impacts the number of Internet users who have access to our merchant advertisers listings and the rate at which our merchant advertisers are able to convert clicks from these Internet users into completed transactions, such as a purchase or sign up. Our current growth also depends on our ability to continue to increase the number of merchant advertisers who use our services and the amount these merchant advertisers spend on our services.

We anticipate that these variables will fluctuate in the future, affecting our growth rate and our financial results. In particular, it is difficult to project the number of click-throughs we will deliver to our merchant advertisers and how much merchant advertisers will spend with us, and it is even more difficult to anticipate the average revenue per click-through.

In addition, we believe we will experience seasonality. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of Internet usage and seasonal purchasing cycles of many merchant advertisers. It is generally understood that during the spring and summer months, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and results.

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Service Costs

Our service costs represent the cost of providing our performance-based advertising services and our search marketing services. The service costs that we have incurred in the periods presented primarily include:

- user acquisition costs;
- amortization and impairment of intangible assets;
- license and content fees;
- credit card processing fees;
- network operations;
- serving our search results;
- maintaining our Web sites;
- domain name registration renewal fees;
- network fees;
- fees paid to outside service providers;
- delivering customer service;
- depreciation of our Web sites and network equipment;
- colocation service charges of our Web site equipment;
- bandwidth and software license fees;
- salaries of related personnel; and

- stock-based compensation of related personnel.

User Acquisition Costts

For the periods presented the largest component of our service costs consists of user acquisition costs that relate primarily to payments to our distribution partners for access to their online user traffic. We enter into agreements of varying durations with distribution partners that integrate our services into their sites and indexes. The primary economic structure of our distribution partner agreements is a variable payment based on a specified percentage of revenue. These variable payments are often subject to minimum payment amounts per click-through. Other economic structures that we may use to a lesser degree include:

- fixed payments, based on a guaranteed minimum amount of usage delivered;
- variable payments based on a specified metric, such as number of paid click-throughs; and
- a combination arrangement with both fixed and variable amounts.

Our method of expensing user acquisition costs is based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments are generally expensed at the greater of: (1) pro-rata over the term the fixed payment covers; or (2) usage delivered to date divided by the guaranteed minimum amount of usage delivered. Agreements with variable payments based on a percentage of revenue, number of paid click-throughs or other metrics are generally expensed based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Sales and Marketing

Sales and marketing expenses consist primarily of:

- payroll and related expenses for personnel engaged in marketing and sales functions;

advertising and promotional expenditures including online and outside marketing activities;

cost of systems used to sell to and serve merchant advertisers; and

stock-based compensation of related personnel.

Product Development

Product development costs consist primarily of expenses incurred in the research and development, creation and enhancement of our Web sites and services.

Our research and development expenses include:

compensation and related expenses;

costs of computer hardware and software;

costs incurred in developing features and functionality of the services we offer; and

stock-based compensation of related personnel.

For the periods presented, substantially all of our product development expenses are research and development.

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with the American Institute of Certified Public Accountants Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. This statement requires that costs incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

General and Administrative

General and administrative expenses consist primarily of:

payroll and related expenses for executive and administrative personnel;

professional services, including accounting, legal and insurance;

bad debt provisions;

facilities costs;

other general corporate expenses; and

- stock-based compensation of related personnel.

Stock-Based Compensation

Prior to January 1, 2006, we accounted for stock-based compensation under APB 25 and used the intrinsic value method. In accordance with APB 25, stock-based compensation consisted of the following:

- the intrinsic value of employee option and restricted stock issuances in cases where the fair value of the underlying stock was greater than the exercise price on the date of the grant; and

- the fair value of non-employee option issuances.

As of January 1, 2006, we adopted SFAS 123R and account for stock-based compensation under the fair value method. As a result, stock-based compensation consists of the following:

- all share-based compensation arrangements granted after January 1, 2006 and for any such arrangements that are modified, cancelled, or repurchased after that date, and

the portion of previous share-based awards for which the requisite service has not been rendered as of that date, based on the grant-date estimated fair value of those awards estimated in accordance with the pro forma provisions of SFAS 123.

As we adopted SFAS 123R using the modified prospective method, the results for the prior year have not been restated under the fair value method for GAAP purposes.

Stock-based compensation expense has been included in the same lines as compensation paid to the same individuals in the consolidated statement of operations in accordance with SAB 107. Stock-based compensation expense recognized in the prior period has been reclassified to conform to the presentation in the current period.

Amortization of Intangibles from Acquisitions

Amortization of intangible assets excluding goodwill relates to intangible assets identified in connection with our acquisitions.

The intangible assets have been identified as:

- non-competition agreements;
- trade and Internet domain names;
- distributor relationships;
- merchant advertising customer base relationships; and
- acquired technology.

These assets are amortized over useful lives ranging from 12 to 84 months.

Provision for Income Taxes

For income tax purposes, we utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in results of operations in the period that includes the enactment date. A valuation allowance is recorded for deferred tax assets when it is more likely than not that such deferred tax assets will not be realized. Although realization is not assured, the Company believes it is more likely than not, based on its operating performance and projections of future taxable income, that the Company s net deferred tax assets will be realized. In determining that it was more likely than not that the Company would realize the deferred tax assets, factors considered included: historical taxable income, historical trends related to merchant advertiser usage rates and projected revenues and expenses. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if the Company s projections of future taxable income are reduced or if the Company does not perform at the levels it is projecting. This could result in increases to the valuation allowance for deferred tax assets and a corresponding increase to income tax expense of up to the entire net amount of deferred tax assets. From time to time, various state, federal, and other jurisdictional tax authorities undertake reviews of the Company and its filings. The Company believes any adjustments that may ultimately be required as a result of any of these reviews will not be material to the Company s financial statements.

As of September 30, 2006, we had net operating loss, or NOL, carryforwards of $1.7 million, which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in

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certain situations where changes occur in the stock ownership of a company. We believe that such a change has occurred, and that the utilization of the approximately $1.7 million of NOL carryforwards is limited such that substantially all of these NOL carryforwards will never be utilized.

Follow-on Public Offering

In February 2005, we closed a follow-on public offering of 9,200,000 shares of Class B common stock at a public offering price of $20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock at a public offering price of $250 per share and with a liquidation preference of $250 per share. These amounts include the exercise by our underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of total offering costs of $12.2 million, were estimated to be approximately $174.1 million and $55.3 million, respectively, for an aggregate amount of $229.4 million. All of the net proceeds have been used to fund the Name Development and Pike Street asset acquisitions and the IndustryBrains acquisition in 2005, the AreaConnect and Open List asset acquisitions in May 2006, and for working capital and other general corporate purposes.

Holders of the preferred stock are entitled to receive cumulative dividends from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments.

The Company s board of directors has declared and paid the following quarterly dividends on the Company s 4.75% convertible exchangeable preferred stock:

Approval Date	Per share dividend	Date of record	Total amount (in thousands)	Payment date
April 2005	$ 3.00	May 4, 2005	$ 690	May 16, 2005
July 2005	2.97	August 4, 2005	683	August 15, 2005
October 2005	2.97	November 4, 2005	683	November 15, 2005
January 2006	2.97	February 4, 2006	662	February 15, 2006
April 2006	2.97	May 4, 2006	422	May 15, 2006
July 2006	2.97	August 4, 2006	422	August 15, 2006

In October 2006, the Company s board of directors declared a quarterly dividend in the amount of $2.97 per share on its 4.75% convertible exchangeable preferred stock which will be paid on November 15, 2006 to the holders of record as of the close of business on November 4, 2006. This quarterly dividend obligation totals approximately $422,000.

The preferred stock is convertible at the option of the holder at any time into shares of Class B common stock at a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock, based on an initial conversion price of $24.50. The initial conversion price is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change. During 2005, approximately 4,515 shares of preferred stock were converted at the option of the holders into approximately 46,071 shares of the Company s Class B common stock at a conversion price of $24.50 per share. In January 2006, approximately 2,500 shares of preferred stock were converted at the option of the holders into approximately 25,510 shares of the Company s Class B common stock at a conversion price of $24.50 per share. In March 2006, the Company entered into privately negotiated and unsolicited transactions with certain holders of the preferred stock in which such holders converted approximately 80,848 shares of the Company s preferred stock into approximately 824,980 shares of the Company s Class B common stock at a conversion rate of $24.50 per share and received a cash payment from the Company of $12.00 per share of preferred stock for an aggregate

amount of approximately $970,000 in order to induce conversions. The $970,000 was reflected as preferred stock dividends and conversion payment in the Company s financial statements. Approximately 142,137 shares of preferred stock remain outstanding as of September 30, 2006.

We may elect to automatically convert some or all of the preferred stock into shares of Class B common stock if the closing price of our Class B common stock has exceeded $36.75, which is 150% of the conversion price for at least 20 of the 30 consecutive trading days ending within 5 trading days prior to the notice of automatic conversion.

If we elect to automatically convert some or all of the preferred stock into shares of Class B common stock prior to February 15, 2008, we will make an additional payment on the preferred stock equal to the aggregate amount of cumulative dividends that would have accrued and become payable on the preferred stock from February 14, 2005 through and including February 15, 2008, less any dividends already paid on the preferred stock. This additional payment is payable in cash or, at our option, in shares of our Class B common stock, or a combination of cash and shares of Class B common stock.

We may elect to redeem the preferred stock, in whole or in part, at declining redemption prices on or after February 20, 2008.

The terms of the preferred stock contain an exchange right, at our option, to convert the preferred stock, in whole but not in part, on any dividend payment date beginning on February 15, 2006 into our 4.75% convertible subordinated debentures (Debentures) at the rate of $250 principal amount of Debentures for each share of preferred stock. This embedded derivative will be reflected as an asset, if there is any value ascribed to it, and is subject to variable accounting. The right will be marked to market at each reporting date until such time as the right is exercised or expires. Based on a variety of factors including the assessed probability of exercise, no value has been ascribed to this right as of September 30, 2006. The Debentures, if issued, will mature 25 years after the exchange date.

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Results of Operations

The following table presents certain financial data, derived from our unaudited statements of operations, as a percentage of total revenue for the periods indicated. The operating results for the three and nine months ended September 30, 2005 and 2006 and are not necessarily indicative of the results that may be expected for the full year or any future period.

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Revenue	100.0%	100.0%	100.0%	100.0%
Expenses:				
Service costs	53.4%	47.4%	51.8%	47.0%
Sales and marketing	9.8%	18.1%	12.5%	18.4%
Product development	5.0%	7.9%	4.1%	8.3%
General and administrative	7.4%	10.9%	7.3%	9.6%
Amortization of acquired intangible assets	20.3%	16.1%	20.3%	16.4%
Total operating expenses	95.9%	100.4%	96.0%	99.7%
Gain (loss) on sales and diposals of intangible assets, net	0.0%	0.3%	0.0%	-0.2%
Income (loss) from operations	4.1%	(0.0%)	4.0%	0.1%
Other income (expense):				
Interest income	2.1%	2.4%	2.1%	2.6%
Interest expense	0.0%	0.0%	0.0%	0.0%
Other	0.0%	0.0%	0.0%	0.0%
Total other income	2.1%	2.4%	2.1%	2.6%
Income before provision for income taxes	6.2%	2.4%	6.1%	2.7%
Income tax expense	2.8%	2.4%	3.4%	2.5%

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