PIPER JAFFRAY COMPANIES
Form 10-Q
August 01, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the Quarterly Period Ended June 30, 2008

OR

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

For the transition period from __________ to __________

Commission File No. 001-31720

PIPER JAFFRAY COMPANIES

(Exact name of registrant as specified in its charter)

DELAWARE	**30-0168701**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
800 Nicollet Mall, Suite 800 Minneapolis, Minnesota	**55402**
(Address of principal executive offices)	(Zip Code)

(612) 303-6000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer: þ	Accelerated filer: o	Non-accelerated filer: o (Do not check if a smaller reporting company)	Smaller reporting company: o

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

As of July 25, 2008, the registrant had 19,172,678 shares of Common Stock outstanding.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

Piper Jaffray Companies
Consolidated Statements of Financial Condition

(Amounts in thousands, except share data)	**June 30, 2008** (Unaudited)	December 31, 2007
Assets		
Cash and cash equivalents	**$ 33,231**	$ 150,348
Cash and cash equivalents segregated for regulatory purposes	**7,000**	
Receivables:		
Customers	**98,291**	124,329
Brokers, dealers and clearing organizations	**66,128**	87,668
Deposits with clearing organizations	**34,500**	30,649
Securities purchased under agreements to resell	**83,074**	52,931
Financial instruments and other inventory positions owned	**570,671**	550,335
Financial instruments and other inventory positions owned and pledged as collateral	**243,023**	242,214
Total financial instruments and other inventory positions owned	**813,694**	792,549
Fixed assets (net of accumulated depreciation and amortization of $59,877 and $55,508, respectively)	**22,870**	27,208
Goodwill	**284,804**	284,804
Intangible assets (net of accumulated amortization of $6,920 and $5,609, respectively)	**15,833**	17,144
Other receivables	**50,746**	47,719
Other assets	**113,902**	107,807
Total assets	**$ 1,624,073**	$ 1,723,156
Liabilities and Shareholders Equity		
Short-term bank financing	**$ 161,500**	$
Payables:		
Customers	**68,678**	91,272
Checks and drafts	**5,243**	7,444
Brokers, dealers and clearing organizations	**100,960**	23,675
Securities sold under agreements to repurchase	**68,703**	247,202
Financial instruments and other inventory positions sold, but not yet purchased	**182,854**	224,710
Accrued compensation	**49,643**	132,908
Other liabilities and accrued expenses	**62,607**	83,356
Total liabilities	**700,188**	810,567

Shareholders equity:		
Common stock, $0.01 par value:		
Shares authorized: 100,000,000 at June 30, 2008 and December 31, 2007;		
Shares issued: 19,494,488 at June 30, 2008 and December 31, 2007;		
Shares outstanding: 16,093,907 at June 30, 2008 and 15,662,835 at December 31, 2007	**195**	195
Additional paid-in capital	**732,459**	737,735
Retained earnings	**360,829**	367,900
Less common stock held in treasury, at cost: 3,400,581 shares at June 30, 2008 and 3,831,653 shares at December 31, 2007	**(170,695)**	(194,461)
Other comprehensive income	**1,097**	1,220
Total shareholders equity	**923,885**	912,589
Total liabilities and shareholders equity	**$ 1,624,073**	$ 1,723,156

See Notes to Consolidated Financial Statements

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Piper Jaffray Companies
Consolidated Statements of Operations
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(Amounts in thousands, except per share data)	**2008**	2007	**2008**	2007
Revenues:				
Investment banking	**$ 32,184**	$ 74,872	**$ 87,449**	$ 158,605
Institutional brokerage	**51,196**	38,597	**81,008**	80,291
Interest	**13,114**	13,816	**28,273**	31,226
Asset management	**4,697**	72	**8,670**	199
Other income/(loss)	**(460)**	(364)	**(2,060)**	324
Total revenues	**100,731**	126,993	**203,340**	270,645
Interest expense	**5,826**	4,417	**12,704**	11,119
Net revenues	**94,905**	122,576	**190,636**	259,526
Non-interest expenses:				
Compensation and benefits	**65,885**	71,707	**131,136**	151,823
Occupancy and equipment	**8,133**	8,849	**16,243**	16,571
Communications	**5,869**	5,997	**12,608**	12,256
Floor brokerage and clearance	**3,899**	4,176	**6,553**	7,691
Marketing and business development	**7,381**	6,380	**13,477**	12,061
Outside services	**11,431**	9,122	**20,248**	16,439
Other operating expenses	**6,603**	1,194	**9,077**	4,950
Total non-interest expenses	**109,201**	107,425	**209,342**	221,791
Income/(loss) from continuing operations before income tax expense/(benefit)	**(14,296)**	15,151	**(18,706)**	37,735
Income tax expense/(benefit)	**(9,223)**	4,774	**(10,196)**	12,636
Net income/(loss) from continuing operations	**(5,073)**	10,377	**(8,510)**	25,099
Discontinued operations:				
Income/(loss) from discontinued operations, net of tax	**1,439**	(1,051)	**1,439**	(2,355)

Net income/(loss)	**$ (3,634)**	$ 9,326	**$ (7,071)**	$ 22,744
Earnings per basic common share				
Income/(loss) from continuing operations	**$ (0.32)**	$ 0.61	**$ (0.53)**	$ 1.47
Income/(loss) from discontinued operations	**0.09**	(0.06)	**0.09**	(0.14)
Earnings per basic common share	**$ (0.23)**	$ 0.55	**$ (0.44)**	$ 1.33
Earnings per diluted common share				
Income from continuing operations	**N/A**	$ 0.58	**N/A**	$ 1.40
Loss from discontinued operations	**N/A**	(0.06)	**N/A**	(0.13)
Earnings per diluted common share	**N/A**	$ 0.52	**N/A**	$ 1.27
Weighted average number of common shares outstanding				
Basic	**16,072**	17,073	**15,951**	17,072
Diluted	**16,709**	17,919	**16,671**	17,969

N/A Not applicable

See Notes to Consolidated Financial Statements

Piper Jaffray Companies
Consolidated Statements of Cash Flows
(Unaudited)

(Dollars in thousands)	Six Months Ended June 30, **2008**	2007
Operating Activities:		
Net income/(loss)	**$ (7,071)**	$ 22,744
Adjustments to reconcile net income/(loss) to net cash provided by/(used in) operating activities:		
Depreciation and amortization of fixed assets	**4,755**	4,413
Deferred income taxes	**2,331**	8,123
Gain on disposal of fixed assets		314
Stock-based compensation	**22,165**	12,503
Amortization of intangible assets	**1,311**	800
Decrease/(increase) in operating assets:		
Cash and cash equivalents segregated for regulatory purposes	**(7,000)**	
Receivables:		
Customers	**25,991**	(7,217)
Brokers, dealers and clearing organizations	**23,132**	178,566
Deposits with clearing organizations	**(3,851)**	3,802
Securities purchased under agreements to resell	**(30,143)**	11,778
Net financial instruments and other inventory positions owned	**(63,005)**	69,093
Other receivables	**(3,113)**	(1,424)
Other assets	**(8,431)**	(4,551)
Increase/(decrease) in operating liabilities:		
Payables:		
Customers	**(22,588)**	(11,364)
Checks and drafts	**(2,201)**	(4,306)
Brokers, dealers and clearing organizations	**75,430**	(169,257)
Securities sold under agreements to repurchase	**3,015**	1,465
Accrued compensation	**(78,964)**	(77,923)
Other liabilities and accrued expenses	**(21,000)**	(31,690)
Net cash provided by/(used in) operating activities	**(89,237)**	5,869
Investing Activities:		
Purchases of fixed assets, net	**(509)**	(5,500)
Net cash used in investing activities	**(509)**	(5,500)
Financing Activities:		
Increase in securities loaned		408
Decrease in securities sold under agreements to repurchase	**(181,514)**	(38,159)

Increase in short-term bank financing	**161,500**	33,000
Repurchase of common stock	**(8,192)**	(17,442)
Excess tax benefits from stock-based compensation	**792**	2,068
Proceeds from stock option transactions	**20**	2,266
Net cash used in financing activities	**(27,394)**	(17,859)
Currency adjustment:		
Effect of exchange rate changes on cash	**23**	211
Net decrease in cash and cash equivalents	**(117,117)**	(17,279)
Cash and cash equivalents at beginning of period	**150,348**	39,903
Cash and cash equivalents at end of period	**$ 33,231**	$ 22,624
Supplemental disclosure of cash flow information -		
Cash paid/(received) during the period for:		
Interest	**$ 13,095**	$ 10,822
Income taxes	**$ (5,028)**	$ 1,815
Non-cash financing activities -		
Issuance of common stock for retirement plan obligations:		
90,140 shares and 8,619 shares for the six months ended June 30, 2008 and 2007, respectively	**$ 3,704**	$ 598

See Notes to Consolidated Financial Statements

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Piper Jaffray Companies
Notes to the Consolidated Financial Statements
(Unaudited)

Note 1 *Background*

Piper Jaffray Companies is the parent company of Piper Jaffray & Co. (Piper Jaffray), a securities broker dealer and investment banking firm; Piper Jaffray Ltd., a firm providing securities brokerage and investment banking services in Europe headquartered in London, England; Piper Jaffray Asia Holdings Limited, an entity providing investment banking services in China headquartered in Hong Kong; Fiduciary Asset Management, LLC (FAMCO), an entity providing asset management services to clients through separately managed accounts and closed end funds offering an array of investment products; Piper Jaffray Financial Products Inc., an entity that facilitates customer derivative transactions; Piper Jaffray Financial Products II Inc., an entity dealing primarily in variable rate municipal products; and other immaterial subsidiaries. Piper Jaffray Companies and its subsidiaries (collectively, the Company) operate as one reporting segment providing investment banking services, institutional sales, trading and research services, and asset management services. As discussed more fully in Note 4, the Company completed the sale of its Private Client Services branch network and certain related assets to UBS Financial Services, Inc., a subsidiary of UBS AG (UBS), on August 11, 2006, thereby exiting the Private Client Services (PCS) business.

Basis of Presentation

The consolidated financial statements include the accounts of Piper Jaffray Companies, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. All material intercompany balances have been eliminated. Certain financial information for prior periods has been reclassified to conform to the current period presentation.

The consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) with respect to Form 10-Q and reflect all adjustments that in the opinion of management are normal and recurring and that are necessary for a fair statement of the results for the interim periods presented. In accordance with these rules and regulations, certain disclosures that are normally included in annual financial statements have been omitted. The consolidated financial statements included in this Form 10-Q should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles. These principles require management to make certain estimates and assumptions that may affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The nature of the Company s business is such that the results of any interim period may not be indicative of the results to be expected for a full year.

Note 2 *Summary of Significant Accounting Policies*

Refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2007, for a full description of the Company s significant accounting policies. Changes to the Company s significant accounting policies are described below.

Financial Instruments and Other Inventory Positions

Financial instruments and other inventory positions owned and financial instruments and other inventory positions sold, but not yet purchased, are carried at fair value on the consolidated statements of financial condition, with unrealized gains and losses reflected in the consolidated statements of operations. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. the exit price). Securities (both long and short) are recognized on a trade-date basis.

Fair Value Hierarchy

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). Prior to January 1, 2008, the Company followed the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, *Brokers and Dealers in Securities*, when determining fair

value for financial instruments. SFAS 157 defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the inputs used to measure fair value and enhances disclosure requirements for fair value measurements. SFAS 157 maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the observable inputs be used when available. Observable inputs are inputs that market participants

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would use in pricing the asset or liability based on market data obtained from independent sources. Unobservable inputs reflect our assumptions that market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the transparency of inputs as follows:

Level 1 Quoted prices (unadjusted) are available in active markets for identical assets or liabilities as of the report date. A quoted price for an identical asset or liability in an active market provides the most reliable fair value measurement because it is directly observable to the market. The type of financial instruments included in Level 1 are highly liquid instruments with quoted prices such as certain U.S. treasury bonds and U.S. government agency securities, equities listed in active markets and certain firm investments.

Level II Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the report date. The nature of these financial instruments include instruments for which quoted prices are available but traded less frequently, derivative instruments whose fair value have been derived using a model where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data, and instruments that are fair valued using other financial instruments, the parameters of which can be directly observed. Instruments which are generally included in this category are certain U.S. treasury bonds and U.S. government agency securities, corporate bonds, certain municipal bonds, certain asset-backed securities and derivatives.

Level III Instruments that have little to no pricing observability as of the report date. These financial instruments do not have two-way markets and are measured using management s best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation. Instruments included in this category generally include auction rate municipal securities, certain firm investments, certain asset-backed securities, residual interests in securitizations and certain convertible securities.

Valuation of Financial Instruments

When available, the Company values financial instruments at observable market prices, observable market parameters, or broker or dealer prices (bid and ask prices). In the case of financial instruments transacted on recognized exchanges, the observable market prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded.

A substantial percentage of the fair value of the Company s financial instruments and other inventory positions owned, financial instruments and other inventory positions owned and pledged as collateral, and financial instruments and other inventory positions sold, but not yet purchased, are based on observable market prices, observable market parameters, or derived from broker or dealer prices. The availability of observable market prices and pricing parameters can vary from product to product. Where available, observable market prices and pricing or market parameters in a product may be used to derive a price without requiring significant judgment. In certain markets, observable market prices or market parameters are not available for all products, and fair value is determined using techniques appropriate for each particular product. These techniques involve some degree of judgment.

For investments in illiquid or privately held securities that do not have readily determinable fair values, the determination of fair value requires the Company to estimate the value of the securities using the best information available. Among the factors considered by the Company in determining the fair value of such financial instruments are the cost, terms and liquidity of the investment, the financial condition and operating results of the issuer, the quoted market price of publicly traded securities with similar quality and yield, and other factors generally pertinent to the valuation of investments. In instances where a security is subject to transfer restrictions, the value of the security is based primarily on the quoted price of a similar security without restriction but may be reduced by an amount estimated to reflect such restrictions. In addition, even where the value of a security is derived from an independent source, certain assumptions may be required to determine the security s fair value. For instance, the Company assumes that the size of positions in securities that the Company holds would not be large enough to affect the quoted price of the securities if the firm sells them, and that any such sale would happen in an orderly manner. The actual value realized upon disposition could be different from the currently estimated fair value.

Derivative contracts are financial instruments such as forwards, futures, swaps or option contracts that derive their value from underlying assets, reference rates, indices or a combination of these factors. A derivative contract generally

represents future commitments to purchase or sell financial instruments at specified terms on a specified date or to exchange currency or interest payment streams based on the contract or notional amount. Derivative contracts exclude certain cash instruments, such as mortgage-backed securities, interest-only and principal-only obligations and indexed debt instruments that derive their values or contractually required cash flows from the price of some other security or index.

The fair values related to derivative contract transactions are reported in financial instruments and other inventory positions owned and financial instruments and other inventory positions sold, but not yet purchased on the consolidated statements of financial condition and any unrealized gain or loss resulting from changes in fair values of derivatives is reported on the consolidated statements of operations. Fair value

is determined using quoted market prices when available or pricing models based on the net present value of estimated future cash flows. Management deems the net present value of estimated future cash flows model to provide the best estimate of fair value as most of our derivative products are interest rate products. The valuation models used require inputs including contractual terms, market prices, yield curves, credit curves and measures of volatility.

The Company does not utilize hedge accounting as described within SFAS No. 133. Derivatives are reported on a net-by-counterparty basis when a legal right of offset exists and on a net-by-cross product basis when applicable provisions are stated in a master netting agreement. Cash collateral received or paid is netted on a counterparty basis, provided legal right of offset exists.

Note 3 *Recent Accounting Pronouncements*

Effective January 1, 2008, the Company adopted SFAS 157. Prior to January 1, 2008, the Company followed the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, when determining fair value for financial instruments. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. Further, SFAS 157 disallows the use of block discounts on positions traded in an active market and nullifies certain guidance regarding the recognition of inception gains on certain derivative transactions. The impact of adopting SFAS 157 in our first quarter of 2008 was not material to our consolidated financial statements. See Note 6, Fair Value of Financial Instruments to the consolidated financial statements for additional information.

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 permits entities to choose to measure certain financial assets and liabilities and other eligible items at fair value, which are not otherwise currently allowed to be measured at fair value. Under SFAS 159, the decision to measure items at fair value is made at specified election dates on an irrevocable instrument-by-instrument basis. Entities electing the fair value option would be required to recognize changes in fair value in earnings and to expense upfront costs and fees associated with the item for which the fair value option is elected. Entities electing the fair value option are required to distinguish on the face of the statement of financial position, the fair value of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. The Company did not make any elections under SFAS 159 to apply fair value to additional financial assets and liabilities.

Effective January 1, 2008, the Company adopted FSP No. FIN 39-1, Amendment of FASB Interpretation No. 39 (FSP FIN 39-1). FSP FIN 39-1 modifies FIN No. 39, Offsetting of Amounts Related to Certain Contracts, and permits companies to offset cash collateral receivables or payables with net derivative positions under certain circumstances. The adoption of FSP FIN 39-1 did not have a material effect on the consolidated financial statements of the Company.

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations (SFAS 141(R)). SFAS 141(R) expands the definition of transactions and events that qualify as business combinations; requires that acquired assets and liabilities, including contingencies, be recorded at the fair value determined on the acquisition date and changes thereafter reflected in revenue, not goodwill; changes the recognition timing for restructuring costs; and requires acquisition costs to be expensed as incurred. Adoption of SFAS 141(R) is required for combinations after December 15, 2008. Early adoption and retroactive application of SFAS 141(R) to fiscal years preceding the effective date are not permitted.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interest in Consolidated Financial Statements (SFAS 160). SFAS 160 re-characterizes minority interests in consolidated subsidiaries as non-controlling interests and requires the classification of minority interests as a component of equity. Under SFAS 160, a change in control will be measured at fair value, with any gain or loss recognized in earnings. SFAS 160 is effective for fiscal years beginning after December 15, 2008. We are evaluating the impact of SFAS 160 on our consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161). SFAS 161 requires disclosures regarding the location and amounts of derivative instruments in the Company s financial statements; how derivative instruments and related hedged items are accounted for; and how derivative instruments and related hedged items affect the Company s

financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods after November 15, 2008. Early application is permitted. Because SFAS 161 impacts the Company s disclosure and not its accounting treatment for derivative instruments and any related hedged items, the Company s adoption of SFAS 161 will not impact the consolidated financial statements.

Note 4 *Discontinued Operations*

On August 11, 2006, the Company and UBS completed the sale of the Company s PCS branch network under a previously announced asset purchase agreement. The purchase price under the asset purchase agreement was approximately $750 million, which included $500 million for the branch network and approximately $250 million for the net assets of the branch network, consisting principally of customer margin receivables.

In accordance with the provisions of Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144), the results of PCS operations have been classified as discontinued operations for all periods presented. The Company recorded a gain from discontinued operations, net of tax, of $1.4 million for the six months ended June 30, 2008, primarily related to a litigation settlement. The Company may incur discontinued operations expense or income related to changes in litigation reserve estimates for retained PCS litigation matters and for changes in estimates to occupancy and severance restructuring charges if the facts that support the Company s estimates change.

In connection with the sale of the Company s PCS branch network, the Company initiated a plan in 2006 to significantly restructure the Company s support infrastructure. All restructuring costs related to the sale of the PCS branch network are included within discontinued operations in accordance with SFAS 144. See Note 13 for additional information regarding the Company s restructuring activities.

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Note 5 *Financial Instruments and Other Inventory Positions Owned and Financial Instruments and Other Inventory Positions Sold, but Not Yet Purchased*

Financial instruments and other inventory positions owned and financial instruments and other inventory positions sold, but not yet purchased were as follows:

(Dollars in thousands)	**June 30, 2008**	December 31, 2007
Financial instruments and other inventory positions owned:		
Corporate securities:		
Equity securities	**$ 25,174**	$ 14,977
Convertible securities	**84,399**	102,938
Fixed income securities	**34,609**	64,367
Municipal Securities:		
Auction rate municipal securities	**85,025**	202,500
Variable rate demand notes	**43,155**	32,542
Other municipal securities	**314,671**	208,150
Asset-backed securities	**56,016**	44,006
U.S. government agency securities	**84,577**	48,074
U.S. government securities	**34,052**	4,520
Derivative contracts	**40,560**	56,554
Other	**11,456**	13,921
	$ 813,694	$ 792,549
Financial instruments and other inventory positions sold, but not yet purchased:		
Corporate securities:		
Equity securities	**$ 46,218**	$ 66,856
Convertible securities	**319**	4,764
Fixed income securities	**23,994**	26,310
Municipal securities	**420**	11
U.S. government agency securities	**5,466**	25,752
U.S. government securities	**59,055**	33,972
Derivative contracts	**494**	18,388
Other	**46,888**	48,657
	$ 182,854	$ 224,710

At June 30, 2008 and December 31, 2007, financial instruments and other inventory positions owned in the amount of $243.0 million and $242.2 million, respectively, had been pledged as collateral for the Company s repurchase agreements and secured borrowings.

Inventory positions sold, but not yet purchased represent obligations of the Company to deliver the specified security at the contracted price, thereby creating a liability to purchase the security in the market at prevailing prices. The Company is obligated to acquire the securities sold short at prevailing market prices, which may exceed the amount reflected on the consolidated statements of financial condition. The Company economically hedges changes in market value of its financial instruments and other inventory positions owned utilizing inventory positions sold, but not yet purchased, interest rate swaps, futures and exchange-traded options.

Derivative Contract Financial Instruments

The Company uses interest rate swaps, interest rate locks, and forward contracts to facilitate customer transactions and as a means to manage risk in certain inventory positions. Interest rate swaps are also used to manage interest rate exposure associated with holding residual interest securities from the Company s tender option bond program. In addition, the Company enters into total return loan swaps to receive the return on $16.0 million in certain corporate loan assets without transferring actual ownership of the underlying loan to the Company. As of June 30, 2008 and December 31, 2007, the Company was counterparty to notional/contract amounts of $7.8 billion and $7.5 billion, respectively, of derivative instruments.

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The Company s derivative contracts are recorded at fair value. Fair values for derivative contracts represent amounts estimated to be received from or paid to a counterparty in settlement of these instruments. These derivatives are valued using quoted market prices when available or pricing models based on the net present value of estimated future cash flows. The valuation models used require inputs including contractual terms, market prices, yield curves, credit curves and measures of volatility. Derivatives are reported on a net-by-counterparty basis when legal right of offset exists, and on a net-by-cross product basis when applicable provisions are stated in master netting agreements. Cash collateral received or paid is netted on a counterparty basis, provided a legal right of offset exists.

Note 6 *Fair Value of Financial Instruments*

The Company records financial instruments and other inventory positions owned and financial instruments and other inventory positions sold, but not yet purchased, at fair value on the consolidated statements of financial condition with unrealized gains and losses reflected in the consolidated statements of operations.

The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. Financial instruments with readily available active quoted prices for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment used in measuring fair value. Conversely, financial instruments rarely traded or not quoted will generally have less, or no, pricing observability and a higher degree of judgment used in measuring fair value.

The following table summarizes the valuation of our financial instruments by SFAS 157 pricing observability levels as of June 30, 2008:

(Dollars in thousands)	**Level I (1)**	**Level II (1)**	**Level III (1)**	**Counterparty Collateral Netting (2)**	**Total**
Assets:					
Financial instruments and other inventory positions owned:					
Non-derivative instruments	$ 64,039	$ 567,352	$ 141,743	$	$ 773,134
Derivative instruments		40,560			40,560
Total financial instruments and other inventory positions owned:	$ 64,039	$ 607,912	$ 141,743	$	$ 813,694
Investments	$ 81	$	$ 47,446	$	$ 47,527
Level III investments for which the Company does not bear economic exposure			(8,097) (3)		
Level III investments for which the Company bears economic exposure			$ 39,349		
Liabilities:					
Financial instruments and other inventory positions sold, but not yet purchased:					
Non-derivative instruments	$ 65,468	$ 115,012	$ 1,880	$	$ 182,360
Derivative instruments		15,345		(14,851) (4)	494

Total financial instruments and other inventory positions sold, but not yet purchased:	$ 65,468	$ 130,357	$ 1,880	$ (14,851)	$ 182,854
Investments	$	$	$ 4,341	$	$ 4,341

(1) Level I financial instruments included highly liquid instruments with quoted prices such as certain U.S. treasury bonds and U.S. government agency securities, equities listed in active markets and certain firm investments. Level II financial instruments generally include corporate bonds, certain U.S. treasury bonds and U.S. government bonds, certain municipal bonds, certain asset-backed securities and derivatives. Level III financial instruments generally include auction rate municipal securities, certain firm investments, certain asset-backed securities,

residual interests in securitizations and certain convertible securities.

(2) As permitted by FIN 39-1 the Company offsets cash and cash equivalent collateral receivables or payables with net derivative positions under certain circumstances.

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(3) Consists of Level III investments which are attributable to minority investors or attributable to employee interests in certain consolidated funds.

(4) The Company posted $14.9 million of short-term U.S. treasury bonds as collateral at June 30, 2008.

The following table summarizes the changes in fair value carrying values associated with Level III financial instruments during the six months ended June 30, 2008:

(Dollars in thousands)	Non-Derivative Assets	Non-Derivative Liabilities	Investment Assets	Investment Liabilities
Balance at December 31, 2007	**$ 230,703**	**$**	**$ 47,780**	**$ 4,576**
Purchases (sales), net	46,906		2,785	
Net transfers in (out)				
Realized gains (losses) (5)	(1,749)		777	
Unrealized gains (losses) (5)	1,780		(3,819)	(277)
Balance at March 31, 2008	**277,640**		**47,523**	**4,299**
Purchases (sales), net	(159,318)		(209)	
Net transfers in (out)	29,178	1,960	(1,264)	
Realized gains (losses) (5)	(190)	(80)		
Unrealized gains (losses) (5)	(5,567)		1,396	42
Balance at June 30, 2008	**$ 141,743**	**$ 1,880**	**$ 47,446**	**$ 4,341**

(5) Realized and unrealized gains/losses related to non-derivative assets are reported in institutional

brokerage on the consolidated statements of operations. Realized and unrealized gains/losses related to investments are reported in other income/(loss) on the consolidated statements of operations.

Note 7 *Securitizations*

In connection with its tender option bond program, the Company securitizes highly rated municipal bonds. At June 30, 2008 and December 31, 2007, the Company had $339.9 million and $325.6 million, respectively, of par value of municipal bonds in securitization. Each municipal bond is sold into a separate trust that is funded by the sale of variable rate certificates to institutional customers seeking variable rate tax-free investment products. These variable rate certificates reprice weekly. Securitization transactions meeting certain SFAS 140 criteria are treated as sales, with the resulting gain included in institutional brokerage revenue on the consolidated statements of operations. If a securitization does not meet the asset sale requirements of SFAS 140, the transaction is recorded as a borrowing. The Company retains a residual interest in each structure and accounts for the residual interest as a financial instrument owned, which is recorded at fair value on the consolidated statements of financial condition. The fair value of retained interests was $11.5 million and $13.9 million at June 30, 2008 and December 31, 2007, respectively, with a weighted average life of 8.1 years and 8.0 years, respectively. The fair value of retained interests is estimated based on the present value of future cash flows using management s best estimates of the key assumptions expected yield, credit losses of 0 percent and a 12 percent discount rate. At June 30, 2008, the sensitivity of the current fair value of retained interests to immediate 10 percent and 20 percent adverse changes in the key economic assumptions was not material. The Company receives a fee to remarket the variable rate certificates derived from the securitizations.

Certain cash flow activity for the municipal bond securitizations described above includes:

	Six Months Ended June 30,	
(Dollars in thousands)	**2008**	2007
Proceeds from new securitizations	**$77,134**	$29,000
Remarketing fees received	**65**	60
Cash flows received on retained interests	**2,952**	2,562

Three securitization transactions at June 30, 2008 and December 31, 2007 did not meet the asset sale requirements of SFAS 140, causing the Company to consolidate these trusts. Accordingly, the Company recorded an asset for the underlying bonds of $47.7 million (par value $47.5 million) and $49.5 million (par value $49.1 million) as of June 30, 2008 and December 31, 2007, respectively, in financial instruments and other inventory positions owned and a liability for the certificates sold by the trusts for $46.8 million and $48.7 million as of June 30, 2008 and December 31, 2007, respectively, in financial instruments and other inventory positions sold, but not yet purchased, on the consolidated statements of financial condition.

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The Company enters into interest rate swap agreements to manage interest rate exposure associated with holding the residual interest securities from its securitizations, which have been recorded at fair value and resulted in a liability of approximately $8.2 million and $11.1 million at June 30, 2008 and December 31, 2007, respectively.

The Company has contracted with two major third-party financial institutions who act as liquidity providers for the Company s tender option bond securitized trusts. The Company has agreed to reimburse these parties for any losses associated with providing liquidity to the trusts. The maximum exposure to loss at June 30, 2008 was $315.6 million representing the outstanding amount of all trust certificates. This exposure to loss is mitigated by the underlying bonds in the trusts. These bonds had a market value of approximately $319.7 million at June 30, 2008. The Company believes that the likelihood it will be required to fund the reimbursement agreement obligation under any provision of the arrangement is remote, and accordingly, no liability for such guarantee has been recorded in the accompanying consolidated financial statements.

Note 8 *Receivables from and Payables to Brokers, Dealers and Clearing Organizations*

Amounts receivable from brokers, dealers and clearing organizations at June 30, 2008 and December 31, 2007 included:

(Dollars in thousands)	**June 30, 2008**	December 31, 2007
Receivable arising from unsettled securities transactions, net	**$**	$ 591
Deposits paid for securities borrowed	**49,308**	55,257
Receivable from clearing organizations	**7,954**	8,081
Securities failed to deliver	**4,323**	7,647
Other	**4,543**	16,092
	$ 66,128	$ 87,668

Amounts payable to brokers, dealers and clearing organizations at June 30, 2008 and December 31, 2007 included:

(Dollars in thousands)	**June 30, 2008**	December 31, 2007
Payable arising from unsettled securities transactions, net	**$ 71,885**	$
Payable to clearing organizations	**23,881**	12,648
Securities failed to receive	**5,189**	11,021
Other	**5**	6
	$ 100,960	$ 23,675

Deposits paid for securities borrowed approximate the market value of the securities. Securities failed to deliver and receive represent the contract value of securities that have not been delivered or received by the Company on settlement date.

Note 9 *Other Assets*

Other assets includes investments in partnerships and investments to fund deferred compensation liabilities that are valued at fair value, net deferred tax assets, income tax receivable and prepaid expenses. In addition, other assets includes 55,440 shares of NYSE Euronext, Inc. common stock subject to restrictions on transfer until March 2009. Fair value of these shares are determined based upon quoted market prices with a valuation adjustment for the restriction.

Other assets at June 30, 2008 and December 31, 2007 included:

	June 30, 2008	December 31, 2007
Investments	**$ 47,527**	$ 47,780
Deferred income tax asset	**39,387**	41,718
Income taxes receivable	**16,210**	6,513
Prepaid expenses	**9,525**	7,596
Other	**1,253**	4,200
Total other assets	**$ 113,902**	$ 107,807

Note 10 *Goodwill and Intangible Assets*

The following table presents the changes in the carrying value of goodwill and intangible assets for the six months ended June 30, 2008:

(Dollars in thousands)	
Goodwill	
Balance at December 31, 2007	$ 284,804
Goodwill acquired	
Impairment losses	
Balance at June 30, 2008	$ 284,804

(Dollars in thousands)	
Intangible assets	
Balance at December 31, 2007	$ 17,144
Intangible assets acquired	
Amortization of intangible assets	(1,311)
Impairment losses	
Balance at June 30, 2008	$ 15,833

Note 11 *Financing*

The Company has discretionary short-term financing available on both a secured and unsecured basis. In addition, the Company has established arrangements to obtain financing using as collateral the Company s securities held by its clearing bank and by another broker dealer at the end of each business day. Repurchase agreements are also used as sources of funding.

On February 19, 2008, the Company expanded its available secured financing by entering into a $600 million revolving credit facility with U.S. Bank N.A. pursuant to which the Company is permitted to request advances to fund certain short-term municipal securities (including auction rate securities and variable rate demand notes). The advances are secured by certain pledged assets of the Company, which consist primarily of certain short-term municipal securities. Interest is paid monthly, and the unpaid principal amount of all advances will be due on August 19, 2008. Advances may be prepaid in whole or in part at any time without penalty. At June 30, 2008, the Company had advances against this line of credit of $13.5 million.

The Company s short-term financing bears interest at rates based on the federal funds rate. At June 30, 2008 and 2007, the weighted average interest rate on borrowings was 2.96 percent and 5.69 percent, respectively. At June 30, 2008 and December 31, 2007, no formal compensating balance agreements existed, and the Company was in compliance with all debt covenants related to its financing facilities.

On December 31, 2007, the Company entered into an agreement whereby U.S. Bank N.A. agreed to provide up to $50 million in temporary subordinated debt upon approval by the Financial Industry Regulatory Authority (FINRA).

Note 12 *Legal Contingencies*

The Company has been named as a defendant in various legal proceedings arising primarily from securities brokerage and investment banking activities, including certain class actions that primarily allege violations of securities laws and seek unspecified damages, which could be substantial. Also, the Company is involved from time to time in investigations and proceedings by governmental agencies and self-regulatory organizations.

The Company has established reserves for potential losses that are probable and reasonably estimable that may result from pending and potential complaints, legal actions, investigations and proceedings. The Company s reserves totaled $7.0 million and $8.4 million at June 30, 2008 and December 31, 2007, respectively. In addition to the Company s established reserves, U.S. Bancorp, from whom the Company spun-off on December 31, 2003, has agreed

to indemnify the Company in an amount up to $17.5 million for certain legal and regulatory matters. Approximately $12.8 million of this amount remained available as of June 30, 2008.

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As part of the asset purchase agreement between UBS and the Company for the sale of the PCS branch network, UBS agreed to assume certain liabilities of the PCS business, including certain liabilities and obligations arising from litigation, arbitration, customer complaints and other claims related to the PCS business. In certain cases, we have agreed to indemnify UBS for litigation matters after UBS has incurred costs of $6.0 million related to these matters and as of the second quarter of 2008, we have exceeded this $6.0 million threshold. In addition, we have retained liabilities arising from regulatory matters and certain litigation relating to the PCS business prior to the sale. The amount of exposure in excess of the $6.0 million indemnification threshold and for other PCS litigation matters deemed to be probable and reasonably estimable are included in the Company s established reserves. Adjustments to litigation reserves for matters pertaining to the PCS business are included within discontinued operations on the consolidated statements of operations.

Given uncertainties regarding the timing, scope, volume and outcome of pending and potential litigation, arbitration and regulatory proceedings and other factors, the amounts of reserves are difficult to determine and of necessity subject to future revision. Subject to the foregoing, management of the Company believes, based on its current knowledge, after consultation with outside legal counsel and after taking into account its established reserves, the U.S. Bancorp indemnity agreement, the assumption by UBS of certain liabilities of the PCS business and our indemnification obligations to UBS, that pending legal actions, investigations and proceedings will be resolved with no material adverse effect on the consolidated financial condition of the Company. However, if during any period a potential adverse contingency should become probable or resolved for an amount in excess of the established reserves and/or the U.S. Bancorp indemnification, the results of operations in that period could be materially adversely affected.

Note 13 *Restructuring*

The Company implemented a specific restructuring plan in 2006 to reorganize the Company s support infrastructure as a result of the PCS branch network sale to UBS. The following table presents a summary of activity with respect to the restructuring-related liabilities included in other liabilities and accrued expenses on the consolidated statements of financial condition:

(Dollars in thousands)	PCS Restructuring
Balance at December 31, 2007	**$ 14,566**
Provisions charged to discontinued operations	(2,000)
Cash outlays	(2,476)
Non-cash write-downs	(230)
Balance at June 30, 2008	**$ 9,860**

Note 14 *Shareholders Equity*

Issuance of Shares

During the six months ended June 30, 2008, the Company issued 90,140 common shares out of treasury in fulfillment of $3.7 million in obligations under the Piper Jaffray Companies Retirement Plan and issued 341,798 common shares out of treasury as a result of vesting and exercise transactions under the Piper Jaffray Companies Amended and Restated 2003 Annual and Long-Term Incentive Plan (the Incentive Plan).

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Note 15 *Earnings Per Share*

Basic earnings per common share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is calculated by adjusting the weighted average outstanding shares to assume conversion of all potentially dilutive restricted stock and stock options. The computation of earnings per share is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Amounts in thousands, except per share data)	**2008**	2007	**2008**	2007
Net income/(loss)	**$ (3,634)**	$ 9,326	**$ (7,071)**	$ 22,744
Shares for basic and diluted calculations:				
Average shares used in basic computation	**16,072**	17,073	**15,951**	17,072
Stock options	**26**	118	**37**	125
Restricted stock	**611**	728	**683**	772
Average shares used in diluted computation	**16,709**	17,919	**16,671**	17,969
Earnings per share:				
Basic	**$ (0.23)**	$ 0.55	**$ (0.44)**	$ 1.33
Diluted	**N/A** (1)	$ 0.52	**N/A** (1)	$ 1.27

N/A Not applicable

(1) In accordance with SFAS 128, earnings per diluted common share is not calculated in periods when a loss is incurred.

Note 16 *Stock-Based Compensation*

The Company maintains one stock-based compensation plan, the Incentive Plan. The Incentive Plan permits the grant of equity awards, including non-qualified stock options and restricted stock, to the Company s employees and directors subject to a limit of 5.5 million shares of common stock. The Company periodically grants shares of restricted stock and options to purchase Piper Jaffray Companies common stock to employees and grants options to purchase Piper Jaffray Companies common stock and shares of Piper Jaffray Companies common stock to its non-employee directors. The Company believes that such awards help align the interests of employees and directors with those of shareholders and serve as an employee retention tool. The awards granted to employees have the following vesting periods: approximately 77 percent of the value of awards have three-year cliff vesting periods, approximately 10 percent of the value of awards vest ratably from 2010 through 2013 on the annual grant date anniversary, and approximately 13 percent of the value of awards cliff vest upon meeting a specific performance-based metric prior to May 2013. The director awards are fully vested upon grant. The maximum term of the stock options granted to employees and directors is ten years. The plan provides for accelerated vesting of the majority of option and restricted stock awards if there is a change in control of the Company (as defined in the plan), in the event of a participant s death, and at the discretion of the compensation committee of the Company s board of directors.

Prior to January 1, 2006, the Company accounted for stock-based compensation under the fair value method of accounting as prescribed by SFAS 123, as amended by SFAS 148. As such, the Company recorded stock-based compensation expense in the consolidated statements of operations at fair value as of the grant date, net of estimated

forfeitures.

Effective January 1, 2006, the Company adopted the provisions of SFAS 123(R) using the modified prospective transition method. SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the statements of operations based on fair value as of the grant date, net of estimated forfeitures. Because the Company historically expensed all equity awards based on the fair value method, net of estimated forfeitures, SFAS 123(R) did not have a material effect on the Company s measurement or recognition methods for stock-based compensation.

Employee and director stock options granted prior to January 1, 2006, were expensed by the Company on a straight-line basis over the option vesting period, based on the estimated fair value of the award on the date of grant using a Black-Scholes option-pricing model. Employee and director stock options granted after January 1, 2006, are expensed by the Company on a straight-line basis over the required service period, based on the estimated fair value of the award on the date of grant using a Black-Scholes option-pricing model. At the time it adopted SFAS 123(R), the Company changed the expensing period from the vesting period to the required service period, which shortened the period over which options are expensed for employees who are retiree-eligible on the date of grant or become retiree-eligible during the vesting period. The number of employees that fell within this category at January 1, 2006 was not material. In accordance with SEC guidelines, the Company did not alter the expense recorded in connection with prior option grants for the change in the expensing period.

Employee restricted stock grants prior to January 1, 2006, are amortized on a straight-line basis over the vesting period based on the market price of Piper Jaffray Companies common stock on the date of grant. Service-based restricted stock grants after January 1, 2006, are valued at the market price of the Company s common stock on the date of grant and amortized on a straight-line basis over the required service period.

The majority of the Company s restricted stock grants provide for continued vesting after termination, so long as the employee does not violate certain post-termination restrictions, as set forth in the award agreements or any agreements entered into upon termination. The Company considers the required service period to be the greater of the vesting period or the post-termination restricted period. The Company believes that the post-termination restrictions meet the SFAS 123(R) definition of a substantive service requirement.

Performance-based restricted stock awards granted in 2008 are valued at the market price of the Company s common stock on the date of grant. The restricted shares are amortized on a straight-line basis over the period the Company expects the performance target to be met. The performance condition must be met for the awards to vest and total compensation cost will be recognized only if the performance condition is satisfied. The probability that the performance conditions will be achieved and that the awards will vest is reevaluated each reporting period with changes in actual or estimated outcomes accounted for using a cumulative effect adjustment.

The Company recorded compensation expense, net of estimated forfeitures, within continuing operations of $12.1 million and $7.0 million for the three months ended June 30, 2008 and 2007, respectively, and $21.9 million and $12.4 million for the six months ended June 30, 2008 and 2007, respectively, related to employee stock option and restricted stock grants. The tax benefit related to the total compensation cost for stock-based compensation arrangements totaled $4.6 million and $2.7 million for the three months ended June 30, 2008 and 2007, respectively, and $8.4 million and $4.8 million for the six months ended June 30, 2008 and 2007, respectively.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option-pricing model, which is based on assumptions such as the risk-free interest rate, the dividend yield, the expected volatility and the expected life of the option. The risk-free interest rate assumption is derived from the U.S. treasury bill rate with a maturity equal to the expected life of the option. The dividend yield assumption is derived from the assumed dividend payout over the expected life of the option. The expected volatility assumption for 2008 grants is derived from a combination of Company historical data and industry comparisons. The Company has only been a publicly traded company since the beginning of 2004; therefore, it does not have sufficient historical data to determine an appropriate expected volatility solely from the Company s own historical data. The expected life assumption is based on an average of the following two factors: 1) industry comparisons; and 2) the guidance provided by the SEC in Staff Accounting Bulletin No. 107, (SAB 107). SAB 107 allows the use of an acceptable methodology under which the Company can take the midpoint of the vesting date and the full contractual term. The following table provides a summary of the valuation assumptions used by the Company to determine the estimated value of stock option grants in Piper Jaffray Companies common stock for the six months ended June 30:

	2008	2007
Weighted average assumptions in option valuation:		
Risk-free interest rates	**3.03%**	4.68%
Dividend yield	**0.00%**	0.00%
Stock volatility factor	**33.61%**	32.20%
Expected life of options (in years)	**6.00**	6.00
Weighted average fair value of options granted	**$15.73**	$28.57

The following table summarizes the changes in the Company s outstanding stock options for the six months ended June 30, 2008:

	Options Outstanding	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term (Years)**	**Aggregate Intrinsic Value**
December 31, 2007	470,715	$ 44.99	7.1	$1,988,641
Granted	128,887	41.09		

Exercised	(518)	39.62		
Canceled	(3,388)	42.05		
June 30, 2008	595,696	$ 44.17	7.1	$
Options exercisable at June 30, 2008	404,236	$ 42.62	6.2	$ 30,165

As of June 30, 2008, there was $2.4 million of total unrecognized compensation cost related to stock options expected to be recognized over a weighted average period of 2.31 years.

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Cash received from option exercises for the six months ended June 30, 2008 and 2007, was $0.02 million and $2.3 million, respectively. The tax benefit realized for the tax deduction from option exercises totaled $0 and $0.9 million for the six months ended June 30, 2008 and 2007, respectively.

The following table summarizes the changes in the Company s non-vested restricted stock for the six months ended June 30, 2008:

	Non-Vested Restricted Stock	Weighted Average Grant Date Fair Value
December 31, 2007	1,827,969	$51.93
Granted	1,982,625	41.22
Vested	(536,041)	37.73
Canceled	(23,013)	49.91
June 30, 2008	3,251,540	$47.76

As of June 30, 2008, there was $101.9 million of total unrecognized compensation cost related to restricted stock expected to be recognized over a weighted average period of 2.82 years.

The vesting of stock options and restricted stock generally results in windfall tax benefits or shortfalls. A windfall tax benefit is defined as any corporate income tax benefit realized upon exercise or vesting of an award that exceeds amounts previously recognized in earnings. SFAS 123 (R) states that realized windfall tax benefits are credited to additional-paid-in-capital within the consolidated statement of financial condition. Realized shortfall tax benefits (amounts which are less than that previously recognized in earnings) are first offset against the cumulative balance of windfall tax benefits, if any, and then charged directly to income tax expense. As of June 30, 2008 we had a cumulative windfall tax benefit recorded within additional paid-in capital of $2.9 million.

Note 17 *Geographic Areas*

The following table presents net revenues and long-lived assets by geographic region:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(Dollars in thousands)	**2008**	2007	**2008**	2007
Net revenues:				
United States	**$ 82,374**	$ 108,775	**$ 165,608**	$ 221,559
Europe	**9,173**	6,177	**14,972**	24,821
Asia	**3,358**	7,624	**10,056**	13,146
Consolidated	**$ 94,905**	$ 122,576	**$ 190,636**	$ 259,526

(Dollars in thousands)	**June 30, 2008**	December 31, 2007
Long-lived assets:		
United States	**$ 339,678**	$ 347,885
Europe	**2,511**	2,909
Asia	**20,705**	20,080
Consolidated	**$ 362,894**	$ 370,874

Note 18 *Net Capital Requirements and Other Regulatory Matters*

Piper Jaffray is registered as a securities broker dealer and is a member of various self-regulatory organizations (SROs) and securities exchanges. In July of 2007, the National Association of Securities Dealers, Inc. (NASD) and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (NYSE) consolidated to form FINRA, which now serves as the Company s primary SRO. Piper Jaffray is subject to the uniform net capital rule of the SEC and the net capital rule of FINRA. Piper Jaffray has elected to use the alternative method permitted by the SEC rule, which requires that it maintain minimum net capital of the greater of $1.0 million or 2 percent of aggregate debit balances arising from customer transactions, as such term is defined in the SEC rule. Under the FINRA rule, FINRA may prohibit a member firm from expanding its business or paying dividends if resulting net capital would be less than 5 percent of aggregate debit balances. Advances to affiliates, repayment of subordinated debt, dividend payments and other equity withdrawals by Piper Jaffray are subject to certain notification and other provisions of the SEC and FINRA rules. In addition, Piper Jaffray is subject to certain notification requirements related to withdrawals of excess net capital.

At June 30, 2008, net capital calculated under the SEC rule was $246.2 million, and exceeded the minimum net capital required under the SEC rule by $244.3 million.

Although Piper Jaffray operates with a level of net capital substantially greater than the minimum thresholds established by FINRA and the SEC, a substantial reduction of our capital would curtail many of our revenue producing activities.

Piper Jaffray Ltd., which is a registered United Kingdom broker dealer, is subject to the capital requirements of the U.K. Financial Services Authority (FSA). As of June 30, 2008, Piper Jaffray Ltd. was in compliance with the capital requirements of the FSA.

Piper Jaffray Asia Holdings Limited operates four entities licensed by the Hong Kong Securities and Futures Commission, which are subject to the liquid capital requirements of the Securities and Futures (Financial Resources) Rules promulgated under the Securities and Futures Ordinance. As of June 30, 2008, Piper Jaffray Asia regulated entities were in compliance with the liquid capital requirements of the Hong Kong Securities and Futures Ordinance.

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

The following information should be read in conjunction with the accompanying consolidated financial statements and related notes and exhibits included elsewhere in this report. Certain statements in this report may be considered forward-looking. Statements that are not historical or current facts, including statements about beliefs and expectations, are forward-looking statements. These forward looking statements include, among other things, statements other than historical information or statements of current condition and may relate to our future plans and objectives and results, and also may include our belief regarding the effect of various legal proceedings, as set forth under Legal Proceedings in Part I, Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2007 and in our subsequent reports filed with the SEC. Forward-looking statements involve inherent risks and uncertainties, and important factors could cause actual results to differ materially from those anticipated, including those factors discussed below under External Factors Impacting Our Business as well as the factors identified under Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2007, as updated in our subsequent reports filed with the SEC. These reports are available at our web site at www.piperjaffray.com and at the SEC web site at www.sec.gov. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update them in light of new information or future events.

Executive Overview

Our business principally consists of providing investment banking, institutional brokerage, asset management and related financial services to middle-market companies, private equity groups, public entities, non-profit entities and institutional investors in the United States, Europe and Asia. We generate revenues primarily through the receipt of advisory and financing fees earned on investment banking activities, commissions and sales credits earned on equity and fixed income institutional sales and trading activities, net interest earned on securities inventories, profits and losses from trading activities related to these securities inventories and asset management fees.

The securities business is a human capital business. Accordingly, compensation and benefits comprise the largest component of our expenses, and our performance is dependent upon our ability to attract, develop and retain highly skilled employees who are motivated and committed to providing the highest quality of service and guidance to our clients.

In 2007, we completed two acquisitions that expanded our asset management and capital markets businesses. On September 14, 2007, we acquired Fiduciary Asset Management, LLC (FAMCO), a St. Louis-based asset management firm. On October 2, 2007, we acquired Goldbond Capital Holdings Limited (Goldbond), a Hong Kong-based investment bank. The acquisitions resulted in incremental revenues and expenses in the first two quarters of 2008, when compared with the comparable periods in 2007.

While we plan to continue our focus on revenue growth through expansion of our capital markets and asset management businesses, we remain realistic about the challenging market environment and are carefully evaluating opportunities as they arise. Within our capital markets business, our efforts will be focused on growing our sector expertise, product depth and geographic reach. We expect that future growth from both our businesses will come from a combination of organic growth and acquisitions. In addition, we have begun to use our own capital to a greater extent by engaging in principal activities that leverage our expertise and we intend to increase the amount of capital we have committed to principal activities as opportunities arise. These activities include, among other things, proprietary positions in equity and debt securities of public and private companies, arbitrage trading strategies, proprietary derivative trading and private equity funds. We may also add capital to facilitate these growth initiatives. All of these growth initiatives will require investments in personnel and other expenses, which may have a short-term negative impact on our profitability as it may take time to develop meaningful revenues from them.

RESULTS FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2008

Net revenues from continuing operations for the three months ended June 30, 2008 were $94.9 million, a decline of 22.6 percent compared with the prior-year period. For the three months ended June 30, 2008, we recorded a net loss from continuing operations of $5.1 million, or $0.32 per share, compared to net income of $10.4 million, or $0.58 per diluted share, for the corresponding period in 2007. For the three months ended June 30, 2008, our net loss, including continuing and discontinued operations, was $3.6 million, or $0.23 per share, compared to net income of $9.3 million,

or $0.52 per diluted share, for the prior-year period.

For the six months ended June 30, 2008, net revenues from continuing operations were $190.6 million, a decline of 26.5 percent compared with the prior-year period. For the six months ended June 30, 2008, net loss from continuing operations totaled $8.5 million, or $0.53 per share, compared to net income of $25.1 million, or $1.40 per diluted share, for the first half of 2007. Net loss, including continuing and discontinued

operations, for the six months ended June 30, 2008, was $7.1 million, or $0.44 per share, compared to net income of $22.7 million, or $1.27 per diluted share, for the prior-year period.

Challenging market conditions, particularly within the equity capital markets, continued to negatively impact performance in the second quarter of 2008. In the first half of 2008, just 39 IPOs were completed industry-wide, and only seven of those IPOs were small cap growth companies. Our sales and trading businesses recorded increased revenues in the second quarter of 2008 partially mitigating the significantly reduced investment banking revenues.

EXTERNAL FACTORS IMPACTING OUR BUSINESS

Performance in the financial services industry in which we operate is highly correlated to the overall strength of economic conditions and financial market activity. Overall market conditions are a product of many factors, which are beyond our control and mostly unpredictable. These factors may affect the financial decisions made by investors, including their level of participation in the financial markets. In turn, these decisions may affect our business results. With respect to financial market activity, our profitability is sensitive to a variety of factors, including the demand for investment banking services as reflected by the number and size of equity and debt financings and merger and acquisition transactions, the volatility of the equity and fixed income markets, the level and shape of various yield curves, the volume and value of trading in securities, and the demand for asset management services as reflected by the amount of assets under management.

Factors that differentiate our business within the financial services industry also may affect our financial results. For example, our business focuses on specific industry sectors. These sectors may experience growth or downturns independently of general economic and market conditions, or may face market conditions that are disproportionately better or worse than those impacting the economy and markets generally. In either case, our business could be affected differently than overall market trends. Given the variability of the capital markets and securities businesses, our earnings may fluctuate significantly from period to period, and results for any individual period should not be considered indicative of future results.

OUTLOOK FOR THE REMAINDER OF 2008

Market conditions in the first half of 2008 were very difficult as we experienced significantly reduced equity financing opportunities and a difficult market for our high yield and structured products business. Further, the municipal credit markets were under particular stress in the first quarter of 2008, however, we believe the turmoil in the municipal credit markets has largely abated. Weak economic indicators, recession fears and continued turmoil in the credit markets have caused significant market uncertainty and increased volatility. We anticipate these challenging market conditions to persist through the remainder of 2008. Specifically, we anticipate that equity financing activity will remain depressed through the remainder of 2008, and we do not see improvement in the high yield market in the near term. Continued challenging market conditions will likely have an adverse impact on our overall results of operations.

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Results of Operations
FINANCIAL SUMMARY

The following table provides a summary of the results of our operations and the results of our operations as a percentage of net revenues for the periods indicated.

(Dollars in thoT SIZE="1">	For the Three Months Ended June 30,		2008	As a Percentage of Net Revenues For the Three Months Ended June 30,
	2006	2005	2006	2005
Numerator:				
Income from continuing operations	$ 7,764	$ 7,310	$ 13,967	$ 13,310
Loss from discontinued e-commerce operations	(592)	(210)	(757)	(496)
Net income	7,172	7,100	13,210	12,814
Effect of dilutive securities:				
Amortization of offering costs for zero coupon convertible senior notes	134	187	289	374
Net income adjusted for dilutive securities	$ 7,306	$ 7,287	$ 13,499	$ 13,188
Denominator:				
Weighted average basic common shares outstanding	36,943	36,015	36,856	36,093
Effect of dilutive securities:				
Stock options	1,081	1,570	1,013	1,660
Zero coupon convertible senior notes	1,450	2,011	1,561	2,011
Weighted average diluted common shares outstanding	39,474	39,596	39,430	39,764
Basic income per share from continuing operations	$ 0.21	$ 0.20	$ 0.38	$ 0.37
Basic loss per share from discontinued e-commerce operations	(0.02)	(0.00)	(0.02)	(0.01)
Basic net income per share	$ 0.19	$ 0.20	$ 0.36	$ 0.36
Diluted income per share from continuing operations	$ 0.20	$ 0.19	$ 0.36	$ 0.34
Diluted loss per share from discontinued e-commerce operations	(0.01)	(0.01)	(0.02)	(0.01)
Diluted net income per share	$ 0.19	$ 0.18	$ 0.34	$ 0.33

6. SHARE-BASED COMPENSATION EXPENSE

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

The Company has reserved 9,500,000 shares of new common stock for issuance under the Company s 2000 Stock Incentive Plan. As of June 30, 2006, 1,471,383 shares were available for grant under the plan.

In accordance with SFAS 123(R), effective from January 1, 2006, all share-based payments to employees and directors are recognized in the financial statements based on their grant date fair values. The valuation provisions of SFAS 123(R) apply to new awards, to awards granted to

employees and directors before the adoption of SFAS 123(R) whose related requisite services had not been provided, and to awards which were subsequently modified or cancelled. In March 2005, the SEC issued SAB 107 regarding the SEC s interpretation of SFAS 123(R) and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Under SFAS 123(R), the Company applied the Black-Scholes valuation model in determining the fair value of options granted. Under the transition provisions of SFAS 123(R), the Company recognizes compensation

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SOHU.COM INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

expense on options granted prior to SFAS 123(R) on an accelerated basis over the vesting period of the underlying options, generally ranging from one to four years. Risk free interest rates are decided based on the yield to maturity of US government bonds as at the respective dates of grant of options. Expected life is the number of years that the Company estimates, based primarily on the history, using the plain-vanilla method, that options will be outstanding prior to settlement. Volatility is measured using historical daily price changes of the Company s stock over the respective expected life of the options. Forfeiture rate is estimated based on historical forfeiture patterns and adjusted in accordance with our expectation for the future. There were no options or other share-based awards granted during the six months ended June 30, 2006.

Estimates of fair value are not intended to predict actual future events or the value that ultimately will be realized by employees who receive equity awards, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by the Company under SFAS 123(R).

A summary of option activity under the plan as of June 30, 2006, and changes during the six month period then ended is presented below:

Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2006	3,585,858	$ 14.44	7.99	
Granted				
Exercised	(325,860)	7.44		
Forfeited or expired	(206,634)	18.29		
Outstanding at June 30, 2006	3,053,364	14.92	7.56	$ 34,649
Vested and expected to vest at June 30, 2006*	2,639,773	14.56	7.40	$ 31,086
Exercisable at June 30, 2006	1,687,171	12.43	6.75	$ 23,630

* These are options outstanding as of June 30, 2006 that are already vested and expected to vest in the future.

The aggregate intrinsic value in the preceding table represents the total intrinsic value, based on the Company s closing stock price of $25.79 as of June 30, 2006.

The total intrinsic value of options exercised during the six month period ended June 30, 2006 was $5.3 million.

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(Unaudited)

The following table summarizes significant ranges of outstanding and exercisable options as of June 30, 2006:

	Options Outstanding as of June 30, 2006			Options Exercisable as of June 30, 2006	
Range of Exercise Price	**Number Outstanding**	**Weighted Average Remaining Contractual Life (Years)**	**Weighted Average Exercise Price**	**Number Exercisable**	**Weighted Average Exercise Price**
$0.86 - $1.18	374,471	5.14	$ 0.96	371,181	$ 0.96
$1.37 - $1.81	39,666	6.05	1.44	34,765	1.43
$2.27	59,000	6.31	2.27	52,402	2.27
$3.846	70,841	3.43	3.85	70,841	3.85
$5.875 - $7.64	303,636	5.89	7.18	271,090	7.13
$8.39	37,500	6.53	8.39	18,750	8.39
$13 - $16.84	413,082	7.88	16.15	183,608	15.9
$17 - $22.86	1,365,433	8.86	17.91	425,071	17.9
$23.17 - $34.51	389,735	7.45	28.55	259,463	29.11
	3,053,364			1,687,171	

The effects of application of SFAS 123(R) on the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2006 are summarized as follows (in thousands, except per share data):

	For the three months ended June 30, 2006	For the six months ended June 30, 2006
Decrease in net income from continuing operations	$ 1,271	$ 3,002
Decrease in income before income tax expense	1,271	3,002
Decrease in net income	1,271	3,002
Decrease in basic net income per share	0.04	0.08
Decrease in diluted net income per share	0.03	0.08

During the three and six months ended June 30, 2006, the adoption of SFAS 123(R) did not result in any impact on the cash flows from operating activities, investing activities and financing activities.

As of June 30, 2006, there was $5.9 million of total unrecognized compensation cost related to share-based awards for which services had not been provided. That cost is expected to be recognized over a weighted average period of 1.1 years. The total fair value of options expensed during the three months ended June 30, 2006 was $1.3 million.

There were no capitalized share-based compensation costs during the three and six months ended June 30, 2006 and 2005.

During the three and six months ended June 30, 2006, total cash received from the exercise of stock options amounted to $1.4 million and $2.4 million, respectively.

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(Unaudited)

Pro Forma Information under SFAS 123 for Prior Period

The following table illustrates the effect on net income and income per share if the Company had applied the fair value recognition provisions of SFAS 123, using the Black-Scholes option pricing model, to share-based employee compensation for the three and six months ended June 30, 2005 (in thousands, except per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported:	$ 7,100	$ 12,814
Add: Share-based compensation expense included in reported net income under APB 25		2
Deduct: Share-based compensation expense determined under fair value based method under SFAS 123	(2,113)	(2,893)
Pro forma net income	$ 4,987	$ 9,923
Basic net income per share:		
As reported	$ 0.20	$ 0.36
Pro forma	$ 0.14	$ 0.27
Diluted net income per share:		
As reported	$ 0.18	$ 0.33
Pro forma	$ 0.13	$ 0.26

The fair value of each option granted during the six months ended June 30, 2005 is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Six Months Ended June 30, 2005
Risk-free interest rate	2.70%
Expected life (in years)	2.42
Expected dividend yield	
Volatility	92%

7. VIEs

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

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

Under contractual agreements with the Company, Dr. Zhang and other Sohu employees who are shareholders of the VIEs are required to transfer their ownership in these entities to the Company, if permitted by

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SOHU.COM INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

PRC laws and regulations, or, if not so permitted, to designees of the Company at any time to repay the loans outstanding. All voting rights of the VIEs are assigned to the Company, and the Company has the right to designate all directors and senior management personnel of the VIEs. Dr. Zhang and the other Sohu employees who are shareholders of the VIEs have pledged their shares in the VIEs as collateral for the loans. As of June 30, 2006, the amount aggregate of these loans was $9.8 million.

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

a) Beijing Sohu

Beijing Sohu Online Network Information Services, Ltd (or Beijing Sohu) was incorporated in the PRC in 1998 and engages in Internet information and wireless services in the PRC on behalf of the Company. The registered capital of Beijing Sohu is $242,000. Originally, Dr. Zhang and He Jinmei held 80% and 20% interests in Beijing Sohu, respectively. He Jinmei transferred all of her shares in Beijing Sohu to High Century in June 2005. As a result, Dr. Zhang and High Century hold 80% and 20% interests in Beijing Sohu, respectively.

b) High Century

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

c) Sohu Entertainment

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

d) Sohu Internet

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

e) Goodfeel

Beijing Goodfeel Information Technology Co., Ltd. (or Goodfeel) was incorporated in the PRC in 2001 and engages in value-added telecommunication services in the PRC. The registered capital of Goodfeel is

SOHU.COM INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

$1,208,000. In May 2004, High Century and Sohu Internet acquired 73% and 27% interests in Goodfeel, respectively. In July 2004, High Century and Sohu Internet invested $613,000 and $473,000 in Goodfeel, respectively, so that High Century owned a 58.1% interest in Goodfeel with the remaining 41.9% interest owned by Sohu Internet. In October 2004, to further satisfy PRC regulations, High Century and Sohu Internet transferred their interests in Goodfeel to Deng Xiufeng and Zhou Jing, each of whom is an employee of the Company. As a result, Deng Xiufeng and Zhou Jing own 58.1% and 41.9% interests in Goodfeel, respectively.

f) Huohu

Beijing Huohu Digital Technology Co., Ltd. (or Huohu) was incorporated in the PRC in 2005. Huohu engages in software and technology development for the games business. The registered capital of Huohu is $121,000. Beijing Sohu New Era Information Technology Co., Ltd. (or Sohu Era), one of the indirect China-based subsidiaries of the Company, and an employee of Huohu, hold 75% and 25% interests in Huohu, respectively. The Company provided the employee with a non-interest bearing loan of $31,000 to finance his capital contribution to Huohu. The loan is repayable upon demand by the Company at any time or upon termination of the employment of the employee and can only be repaid through transfer of the employee s shares in Huohu to Sohu Era. Based on the arrangement between Sohu Era and the employee, Sohu Era is the sole and primary beneficiary of Houhu. Accordingly, Huohu is 100% consolidated into the financial statements of the Company.

g) Tu Xing Tian Xia

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

h) Feng Yang Tian Lang

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

i) Sogou Information

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

Pursuant to FIN 46R, Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and Sogou Information are VIEs, of which the Company is the primary beneficiary. Accordingly, the VIEs have been consolidated in the Company s financial statements.

As of June 30, 2006, the above VIEs have aggregate accumulated net profits of approximately $4.4 million which have been reflected in the consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

8. RELATED PARTY TRANSACTIONS

The following table summarizes related party transactions during the three and six months ended June 30, 2006 and 2005, respectively (in thousands):

Name or Description of Related Party	Description of Transactions	Accounting Captions	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Qingfan, a company controlled by Dr Zhang s brother	Delivery service provided by Qingfan	Cost of revenues	$ 9	$ 33	$ 27	$ 64
An investee of the Company	Amortization of licensing fee	Product development expenses	26	25	52	50
	Revenue sharing	Cost of revenues	435	296	881	580

9. COMMITMENTS AND CONTINGENCIES

The Company s China-based subsidiaries and VIEs, Sohu Era, Sohu Internet, Beijing Sogou Technology Development Co., Ltd. (or Sogou Technology) and Sogou Information enjoy tax benefits which are available to new technology enterprises . The effective income tax rate for new technology enterprises registered and operating in Beijing Zhongguancun Science Park is 15%, while the local income tax will be exempted as long as the enterprise holds the status of a new technology enterprise. New technology enterprises are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction, at the rate of 7.5%, for the subsequent three years. Sohu Era and Sohu Internet were incorporated in 2003 and, providing there is no change in their status as a new technology enterprise or a change in the relevant regulations, are subject to an income tax rate of 0% in 2003 to 2005, 7.5% in 2006 to 2008 and 15% thereafter. Sogou Information was incorporated in 2005 and Sogou Technology was incorporated in 2006 and, providing there is no change in their status as a new technology enterprise or a change in the relevant regulations, are subject to an income tax rate of 0% in 2006 to 2008, 7.5% in 2009 to 2011 and 15% thereafter. To be considered a new technology enterprise under current PRC law, a company must: (i) operate in the high-tech industry (which includes the information technology industry); (ii) be incorporated and operate in Beijing Zhongguancun Science Park; (iii) receive 60% of its revenue from high-tech products or services; and (iv) have at least 20% of its employees involved in technology development. New technology enterprises are subject to annual inspection to determine whether they continue to meet these requirements. If Sohu Era, Sohu Internet, Sogou Technology and Sogou Information did not meet the requirements of a new technology enterprise, they could be subject to enterprise income tax in China at rates up to 33%, which could cause a significant reduction in the Company s after-tax income.

The Chinese market in which the Company operates poses certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability of the Company to operate an Internet business, and to conduct brand advertising, sponsored search, wireless and online game services in the PRC. Though the PRC has, since 1978, implemented a wide range of market-oriented economic reforms, continued reforms and progress towards a full market-oriented economy are uncertain. In addition, the telecommunication, information, and media industries remain highly regulated. Restrictions are currently in place or are unclear with respect to which segments of these industries foreign owned entities, like the Company, may operate. The Chinese government may issue from time to time new laws or new interpretations on existing laws to regulate areas such as telecommunication, information and media. Regulatory risks also encompass the interpretation by the tax authorities of current tax laws and regulations, including the applicability of certain preferential tax treatments.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company s legal structure and scope of operations in China could be subjected to restrictions which could result in severe limits to the Company s ability to conduct business in the PRC.

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

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

During the six months ended June 30, 2006, Sohu Internet entered into an agreement and committed to invest $1.2 million in a newly established China-based investment holding company. The registered capital of the investee is $62 million. After the investment, Sohu Internet will hold 2% of equity interests in the investee.

10. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. This Interpretation is effective as of January 1, 2007. The Company is currently evaluating the impact of FIN 48 on its financial statements.

11. SUBSEQUENT EVENTS

In October 2005, the board of directors approved the Company s repurchase of outstanding shares of its common stock from the open market, on an opportunistic basis, up to $15 million. As of August 1, 2006, the Company had repurchased a total of 690,581 shares, fully utilizing the $15 million available under this initial program. On July 25, 2006, the board of directors approved an additional $15 million stock repurchase program.

In July 2006, the Company granted approximately 420,000 restricted stock units to its employees and directors under the 2000 Stock Incentive Plan.

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

As used in this report, references to us, we, our, our company, Sohu and Sohu.com are to Sohu.com Inc. and, except where the context requires otherwise, our subsidiaries, Sohu.com (Hong Kong) Limited (or Sohu Hong Kong), Sohu.com Limited, Kylie Enterprises Limited, All Honest International Limited, Marvel Hero Limited, Go2Map Inc., Sohu.com (Search) Limited, Sogou Inc., Sogou (BVI) Limited, Sohu ITC Information Technology (Beijing) Co., Ltd. (or Beijing ITC), Beijing Sohu New Era Information Technology Co., Ltd. (or Sohu Era), Beijing Sohu Interactive Software Co., Ltd. (or Sohu Software), Go2Map Software (Beijing) Co., Ltd. (or Go2Map Software), Beijing Sogou Technology Development Co., Ltd. (or Sogou Technology), Beijing Sohu New Media Information Technology Co., Ltd. (or Sohu New Media) and our VIEs Beijing Sohu Online Network Information Services, Ltd. (or Beijing Sohu), Beijing Century High Tech Investment Co., Ltd. (or High Century), Beijing Sohu Entertainment Culture Media Co., Ltd. (or Sohu Entertainment, formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd, or Hengda), Beijing Sohu Internet Information Service Co., Ltd. (or Sohu Internet), Beijing Goodfeel Information Technology Co., Ltd. (or Goodfeel), Beijing Huohu Digital Technology Co., Ltd. (or Huohu), Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (or Tu Xing Tian Xia), Beijing Feng Yang Tian Lang Advertising Co., Ltd (or Feng Yang Tian Lang), and Beijing Sogou Information Services Co., Ltd. (or Sogou Information) and these references should be interpreted accordingly. Unless otherwise specified, references to China or PRC refer to the People s Republic of China and do not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words expect, anticipate, intend, believe, or similar language. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our business and financial performance are subject to substantial risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information set forth below under the caption Risk Factors. Readers are cautioned not to place undue reliance on these forward-looking statements.

OVERVIEW

We are a leading online media, search and mobile value-added services company providing comprehensive online products and services to consumers and businesses in China, through our comprehensive matrices of web properties, consisting of the mass portal and leading online media destination www.sohu.com; interactive search engine www.sogou.com; the leading online alumni club www.chinaren.com; the leading games information portal www.17173.com; one of the top real estate Websites www.focus.cn; the wireless value-added services provider www.goodfeel.com.cn; and a leading online mapping service Website www.go2map.com. We offer our user community very broad choices regarding information, entertainment, communication and wireless. We derive revenues primarily through the sale of brand advertising, sponsored search, wireless and online game services. We also sponsor major events to further enhance our viewership and create a positive branding impact.

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

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CRITICAL ACCOUNTING POLICIES AND MANAGEMENT ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe accounting for brand advertising and sponsored search revenues, accounting for wireless revenues and cost of revenues, gross versus net basis of revenue recognition, determination of functional currencies, allowance for doubtful accounts, valuation allowance against deferred tax assets, assessment of impairment for goodwill and other intangible assets and determination of share-based compensation expense represent critical accounting policies that reflect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

Advertising Revenues

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

Brand advertising contracts establish the fixed price and advertising services to be provided. Pursuant to brand advertising contracts, we provide advertisement placements on various Website channels and in different formats, including but not limited to banners, links, logos, buttons, rich media, content integration and email marketing. Revenue is recognized ratably over the period the advertising is provided and, as such, we consider the services to have been delivered. We treat all elements of advertising contracts as a single unit of accounting for revenue recognition purposes. Based upon our credit assessments of our customers prior to entering into contracts, we determine if collectibility is reasonably assured. In situations where collectibility is not deemed to be reasonably assured, we recognize revenue upon payment from the customer.

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

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

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

Non-Advertising Revenues

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

Wireless revenues are derived from providing short messaging services (or SMS), Wireless Application Protocol (or WAP), multi-media messaging services (or MMS), Ring Back Tone (or RBT), and interactive voice response (or IVR), mainly consisting of news, weather forecast, chatting, entertainment information, ring tones and logo downloads and various other mobile related products provided to mobile phone users. Wireless service fees are charged on a monthly or per message/download basis. Wireless revenues and cost of revenues are recognized in the month in which the service is performed, provided no significant Sohu obligations remain. We rely on mobile network operators in China to bill mobile phone users for wireless service fees. In order to meet ownership requirements under PRC law which restrict or prohibit wholly foreign owned enterprises from providing Internet information and value-added telecommunication services such as wireless, we rely on Sohu Internet and Goodfeel to contract with the mobile network operators. Generally, (i) within 15 to 90 days after the end of each month, Sohu Internet or Goodfeel receives statements from each of the operators confirming the amount of wireless service charges billed to that operator s mobile phone users and (ii) within 30 to 180 days after delivering monthly statements, each operator remits the wireless service fees, net of its service fees, for the month to Sohu Internet or Goodfeel. In order to recognize revenue and be paid for services provided, we rely on billing confirmations from the mobile network operators as to the actual amount of services they have billed to their mobile customers. We are unable to collect certain wireless services fees from an operator in certain circumstances due to technical issues with the operator s network. This is referred to as the failure rate , which can vary from operator to operator. At the end of each reporting period, where an operator has not provided Sohu Internet or Goodfeel with the monthly statements for any month confirming the amount of wireless service charges billed to that operator s mobile phone users for the month, Sohu, using information generated from its own internal system and historical data, makes estimates of the failure rate and collectable wireless service fees and accrues revenue accordingly. The quarterly historical differences in our estimated revenue which was recorded in the financial statements compared to the actual revenue have ranged from an underestimation of $535,000 (gross margin underestimate of $326,000) to an overestimation of $160,000 (gross margin overestimate of $120,000) since 2002 when wireless revenues began representing a significant portion of our total revenues. We believe we have the ability to make a reasonable estimate. However, differences between the actual failure rate per an operator s statement and our internal records could result in material differences in the amount and timing of our revenue and non-advertising cost of revenue for any period. For the three months ended June 30, 2006, 87% of our estimated wireless revenues were confirmed by the monthly statements received from the mobile network operators.

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

Based on our assessment, the majority of our wireless revenues are recorded on a gross basis. We have primary responsibility for fulfillment and acceptability of the wireless services. The content and nature of the wireless services are designed and developed by us (either independently or with third parties) and originate from our Websites, our links located on third parties Websites, or one of our dedicated phone numbers. The mobile network operators that we contract with to deliver these services to the end customers are not involved in the design or development of the services that are provided by us. The end customer purchases the wireless content, community access or value-added services, such as news, weather forecast, chatting, entertainment information, music, ring tone, picture and logo downloads that Sohu provides. The end customer receives identical services

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from us regardless of which mobile network operator is used to deliver the message. In addition, we provide customer services to the end customers directly and we could be requested by the mobile network operators to assume the credit risk if the operators are not able to collect fees from the end customers. Sohu has determined that in addition to the indicators of gross reporting, there are also certain indicators of net reporting, including the fact that the mobile network operators set maximum prices that Sohu can charge and that the mobile network operators also have the right to set requirements and procedures associated with using their platform. However, Sohu has determined that the gross revenue reporting indicators are stronger, because Sohu is the primary obligor, adds value to the products, has inventory risk related to content and products, and has reasonable pricing latitude.

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

Functional Currency

Our functional currency is the US Dollar. The functional currency of our subsidiaries and VIEs in China is RMB. An entity s functional currency is the currency of the primary economic environment in which it operates; normally, that is the currency of the environment in which it primarily generates and expends cash. Management s judgment is essential in determination of the functional currency by assessing various indicators, such as cash flow, sales price and market, expenses, financing and inter-company transactions and arrangements. Assets and liabilities of the China subsidiaries and VIEs are translated into US Dollars, our reporting currency, at the exchange rate in effect at the balance sheet date. Foreign currency translation adjustments are not included in determining net income for the period but are accumulated in a separate component of consolidated equity on the balance sheet. The accumulated foreign currency translation adjustment as of June 30, 2006 and December 31, 2005 was a gain of $3.4 million and $2.4 million, respectively.

Allowance for Doubtful Accounts Receivables

Our management must make estimates of the collectibility of our accounts receivables. Management specifically analyzes accounts receivables, historical bad debts, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our accounts receivable balance was $25.6 million, net of allowance for doubtful accounts of $1.9 million as of June 30, 2006. If the financial condition of Sohu s customers or mobile network operators were to deteriorate, resulting in their inability to make payments, or the mobile network operators requested that we assume additional bad debts as a result of the operators inability to collect fees from end customers, additional allowance might be required.

Allowance for Deferred Tax Assets

As of June 30, 2006, the majority of our deferred tax assets are related to net operating losses that would apply to United States income taxes. As substantially all of our income is earned in China, and we do not intend in the foreseeable future to repatriate this income to the United States where it would be taxable, it is more likely than not that deferred tax assets resulting from net operating losses will not be realized. The remaining deferred tax assets are related to China-based subsidiaries and VIEs, resulting from net operating losses and temporary differences between accounting basis and tax basis. We believe that it is more likely than not that the balance will not be realized. We have recorded a full valuation allowance against our gross deferred tax assets in order to reduce our deferred tax assets to the amount that is more likely than not to be realized. If events were to occur in the future that would allow us to realize more of our deferred tax assets than the presently recorded net amount, an adjustment would be made to the deferred tax assets that would increase income for the period when those events occurred.

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Impairment on Long-Lived Assets

Our long-lived assets include goodwill, intangible assets, fixed assets and other assets. We test goodwill for impairment at the reporting unit level (operating segment) on an annual basis, and between annual tests when an event occurs or circumstances change that could more likely than not reduce the fair value of goodwill below its carrying value. Application of a goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and making other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for each reporting unit. Any impairment losses recorded in the future could have a material adverse impact on our financial condition and results of operations. As of June 30, 2006, we did not believe that any event or change of circumstances had occurred that would result in material impairment losses in goodwill.

In respect of our intangible assets, which mainly comprise domain names, trademarks, customer lists and computer software purchased from unrelated third parties, we amortize the costs over their expected future economic lives. Fixed assets comprise computer equipment, office furniture and equipment, vehicles and leasehold improvement, and are depreciated over the estimated useful lives of the assets on a straight-line basis. Other assets mainly include the offering costs of the zero coupon convertible senior notes and rental deposits. We amortize the offering costs of the zero coupon convertible senior notes over a period of four years. Management judgment is required in the assessment of the economic lives of intangible assets and useful lives of the fixed assets and other assets. Based on the existence of one or more indicators of impairment, we measure any impairment of intangible assets, fixed assets and other assets based on a projected discounted cash flow method using a discount rate determined by our management to commensurate with the risk inherent in our business model. An impairment charge would be recorded if we determined that the carrying value of intangible assets, fixed assets or other assets may not be recoverable. Our estimates of future cash flows require significant judgment based on our historical results and anticipated results and are subject to many factors. As of June 30, 2006, we were not aware of any indication of impairment of our intangible assets, fixed assets and other assets.

Share-Based Compensation

Effective from January 1, 2006, we adopted SFAS 123(R), which requires all share-based payments to employees and directors, including grants of employee stock options, to be recognized in the financial statements based on their grant date fair values. The valuation provisions of SFAS 123(R) apply to new awards, to awards granted to employees and directors before the adoption of SFAS 123(R) whose related requisite services had not been provided, and to awards which were subsequently modified or cancelled. In March 2005, the SEC issued SAB 107 regarding the SEC s interpretation of SFAS 123(R) and the valuation of share-based payments for public companies. We have applied the provisions of SAB 107 in its adoption of SFAS 123(R). Prior to SFAS 123(R), we accounted for share-based payments in accordance with APB 25, and complied with the disclosure provisions of SFAS 123. In general, compensation cost under APB 25 was recognized based on the difference, if any, between the estimated fair value of our common stock and the amount an employee must pay to acquire the stock, as determined on the date the option is granted. Pro forma information was disclosed to illustrate the effect on net income and net income per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the reporting periods.

As of January 1, 2006, we adopted SFAS 123(R) using the modified prospective method. The fair value of the options granted before January 1, 2006 is determined based on the Black-Scholes valuation model, which is consistent with the valuation techniques utilized when we prepared pro forma information under SFAS 123. Such fair value of the options is recognized as share-based payments over the requisite service period, net of estimated forfeitures on an accelerated basis under SFAS 123(R). There were no options or other share-based awards granted during the six months ended June 30, 2006.

The determination of the fair value of share-based awards and related share-based compensation expense requires input of subjective assumptions, including but not limited to the valuation model adopted, risk-free

interest rate, expected life of the share-based awards, stock price volatility, and expected forfeiture rate. The selection of an appropriate valuation technique or model depends on the substantive characteristics of the instrument being valued. Risk free interest rates are decided based on the yield to maturity of US government bonds as at respective dates of grant of options. Expected life is the number of years that we estimate, based primarily on the history, using plain-vanilla method, that options will be outstanding prior to settlement. Volatility is measured using historical daily price changes of our stock over the respective expected life of the option. Forfeiture rate is estimated based on historical forfeiture pattern and adjusted in accordance with our expectation for the future.

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

RESULTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2006 AND 2005

Demonstrating our full dedication to our core business of brand advertising and sponsored search, on June 20, 2006, we had discontinued our unprofitable e-commerce business. As a result of the disposal, the e-commerce business is accounted for as a discontinued operation. Accordingly, our income statement separates the discontinued operation for all periods presented.

REVENUES

Total revenues were $34.1 million and $64.5 million for the three and six months ended June 30, 2006, respectively, as compared to $25.0 million and $47.5 million for the corresponding periods in 2005.

Advertising Revenues

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

Advertising revenues were $22.8 million and $43.0 million, or 67% of total revenues for both the three and six months ended June 30, 2006, as compared to $17.0 million and $31.8 million, or 68% and 67% of total revenues for the corresponding periods in 2005. For the three and six months ended June 30, 2006, advertising revenues consisted of revenues from brand advertising of $19.3 million and $36.0 million, and revenues from sponsored search of $3.5 million and $7.0 million. For the three and six months ended June 30, 2005, advertising revenues consisted of revenues from brand advertising of $13.9 million and $26.0 million, and revenues from sponsored search of $3.1 million and $5.8 million.

Brand advertising. Brand advertising revenues increased by $5.4 million to $19.3 million for the three months ended June 30, 2006 and increased by $10.0 million to $36.0 million for the six months ended June 30, 2006 as compared to the corresponding three and six month periods in 2005. The increase of $5.4 million for the three months ended June 30, 2006 from the corresponding period in 2005 consisted of: (i) a $6.9 million increase from advertisers who advertised with us during the three months ended June 30, 2006 but did not advertise on our Website during the three months ended June 30, 2005; (ii) a $4.7 million increase in revenues from the advertisers who advertised with us in the three months ended June 30, 2005 and continued to do so in the three months ended June 30, 2006; and were offset by (iii) a $6.2 million decrease in revenues as some of the advertisers who advertised with us during the three months ended June 30, 2005 did not advertise on our Website during the three months ended June 30, 2006. The increase of $10.0 million for the six months ended June 30, 2006 from the corresponding period in 2005 consisted of: (i) a $11.0 million increase from advertisers who advertised with us during the six months ended June 30, 2006 but did not advertise on our Website during the six

months ended June 30, 2005; (ii) a $8.3 million increase in revenues from the advertisers who advertised with us in the six months ended June 30, 2005 and continued to do so in the six months ended June 30, 2006; and were offset by (iii) a $9.3 million decrease in revenues as some of the advertisers who advertised with us during the six months ended June 30, 2005 did not advertise on our Website during the six months ended June 30, 2006. No single customer accounted for more than 10% of total brand advertising revenues for each of the three and six months ended June 30, 2006 and 2005. As of June 30, 2006 and 2005, we had $1.2 million and $0.9 million of receipt in advance from advertisers, respectively. We have not recorded any revenue from advertising-for-advertising barter transactions.

For the three and six months ended June 30, 2006, we recorded brand advertising revenues of approximately $0 and $40,000, respectively, from Fujian Tian Qing Digital Co., Ltd. (or Fujian Tian Qing), formerly known as NetDragon Websoft Inc., in connection with its advertisements on our 17173.com Website. For the three and six months ended June 30, 2005, we recorded brand advertising revenues of approximately $204,000 and $396,000, respectively. Those advertising services are provided pursuant to a three-year advertising framework agreement expiring in November 2006. Fujian Tian Qing was the previous owner of 17173.com Website prior to our acquisition of 17173.com.

We expect brand advertising revenues to increase in the third quarter of 2006 as compared to the second quarter of 2006.

Sponsored search. Sponsored search services revenues increased by $0.4 million to $3.5 million for the three months ended June 30, 2006 and increased by $1.2 million to $7.0 million for the six months ended June 30, 2006, as compared to the corresponding three and six month periods in 2005. Sponsored search services primarily include priority placements in our search directory and listing in our classified advertisement section, in addition to pay-for-click services of displaying the text-based links of our advertisers on our Websites and our Website Alliance network. We normally provide priority placement services and listings in our classified advertisement section for a fixed fee over a period. Pay-for-click services displaying the text-based links to our advertiser s Websites charged on a cost-per-click basis, so that an advertiser pays us only when a user clicks on the displayed link on our Websites or on our Website Alliance network. The priority of the display of text-based links is based on the bidding price of different advertisers. For the three and six months ended June 30, 2006, revenues from priority placement services and our classified advertisement section amounted to $2.5 million and $5.0 million, being flat from the corresponding three month period in 2005 and a 11% increase over the corresponding six month period in 2005, respectively. For the three and six months ended June 30, 2006, revenues from pay-for-click services amounted to $1.0 million and $2.0 million, respectively, representing a 43% and 54% increase from the corresponding periods of 2005. Revenues from pay-for-click services accounted for approximately 30% of the total sponsored search revenues for both the three and six month periods ended June 30, 2006 as compared to 23% for the corresponding periods in 2005. The increase in revenues from pay-for-click services mainly resulted from an increase in the number of sponsored links, a higher average price per click-through, and an increase in the clicks of the sponsored links due to increased traffic and expansion of Website Alliance network.

We expect sponsored search revenues to be flat or up slightly in the third quarter of 2006 as compared to the second quarter of 2006.

Non-advertising Revenues

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

Non-advertising revenues were $11.2 million and $21.5 million or 33% of total revenues for both the three and six months ended June 30, 2006, as compared to $8.1 million and $15.7 million, or 32% and 33% of total revenues for the corresponding three and six month periods in 2005. For the three and six months ended June 30, 2006, non-advertising revenues consisted of wireless revenues of $9.0 million and $17.0 million, and from other

services of $2.2 million and $4.5 million, respectively. For the three and six months ended June 30, 2005, non-advertising revenues consisted of revenues from wireless of $6.4 million and $12.3 million, and from other services of $1.7 million and $3.4 million, respectively.

Wireless. Our wireless revenues include SMS, WAP, MMS, RBT and IVR services. Our wireless services include news, weather forecast, chatting, entertainment information, music, ring tone, picture and logo downloads and various other related products provided to mobile phone users. Most of our services are charged on a monthly or per message/download basis. For the six months ended June 30, 2006, we normally charge monthly fees ranging from $0.062 to $3.747 and per message/download fees ranging from approximately $0.006 to $0.500.

For the three months ended June 30, 2006, our wireless revenues increased by $2.6 million to $9.0 million as compared to $6.4 million for the three months ended June 30, 2005, primarily due to an increase of $1.9 million in SMS revenues and $1.2 million in WAP, MMS and RBT revenues. This increase was partially offset by a decrease of $0.5 million in IVR revenues. For the six months ended June 30, 2006, our wireless revenues increased by $4.7 million to $17.0 million as compared to $12.3 million for the six months ended June 30, 2005, primarily due to an increase of $3.3 million in SMS revenues and $2.2 million in WAP, MMS and RBT revenues. This increase was partially offset by a decrease of $0.8 million in IVR revenues. The increase in SMS revenues was primarily due to further cooperation with mobile network operators, and the increase in WAP and RBT revenues was the result of our product enhancement and improvement of our ranking in Monternet. The increase in MMS revenues resulted from the resumption of our MMS revenues services by China Mobile Communications Corporation (or CMCC) beginning on August 1, 2005. The decrease in IVR revenues was mainly due to our limited marketing activities for this product.

In early July 2006, the two major mobile network operators in China, CMCC and Unicom Corporation Limited (or Unicom), introduced new policies on wireless value added services, including extension of trial periods and double reminders for new monthly subscriptions, billing reminders to existing monthly subscribers and conversion of per message-based SMS subscription to monthly subscriptions. For the three months ended June 30, 2006, wireless revenue from CMCC amounted to $4.6 million, out of which about $1.6 million is related to services and products which are affected by the new policies. Similarly, wireless revenue from Unicom amounted to $4.0 million, out of which $2.1 million can be expected to be affected. Without any additional measure or changes in policies and regulations, we expect such new policies will reduce our wireless revenues by $1.5 million to $2.5 million per quarter for the third and fourth quarter of 2006.

Others. Our other services consist primarily of online game services and design of Website for third parties. On May 31, 2005, we completed the acquisition of Go2Map. We have included in revenues the sales of software and applications service provider (or ASP) services of $110,000 and $250,000 for the three and six months ended June 30, 2006 related to Go2Map, as compared to $201,000 for the period from May 31, 2005 to June 30, 2005.

COSTS AND EXPENSES

Cost of Revenues

Total cost of revenues were $12.1 million and $22.2 million for the three and six months ended June 30, 2006, respectively, as compared to $7.7 million and $13.9 million for the corresponding three and six month periods in 2005.

Advertising Cost of Revenues

Advertising cost of revenues increased by $2.8 million to $6.9 million for the three months ended June 30, 2006 as compared to the corresponding period in 2005, and increased by $4.9 million to $12.3 million for the six months ended June 30, 2006 as compared to the corresponding period in 2005.

Brand advertising. Brand advertising cost of revenues includes personnel costs and personnel overheads relating to our editorial center, content purchases, payments to our business partners, relevant depreciation of servers and computer equipment and bandwidth leasing costs. Brand advertising cost of revenues was $5.6 million and $9.9 million for the three and six months ended June 30, 2006, respectively, as compared to $3.4 million and $6.2 million for the corresponding three and six month periods in 2005. The increase of $2.2 million for the three months ended June 30, 2006 from the corresponding period in 2005 consisted of a $765,000 increase in content purchases, a $449,000 increase in bandwidth leasing costs due to the requirement of the expanded business, a $315,000 increase in personnel expense, a $264,000 expense of share-based compensation due to the adoption of SFAS 123(R), a $217,000 increase in office and depreciation expense and a $190,000 increase in payments to our business partners. The increase of $3.7 million for the six months ended June 30, 2006 from the corresponding period in 2005 consisted of a $903,000 increase in content purchases, a $725,000 increase in personnel expense, a $719,000 increase in bandwidth leasing costs, a $603,000 expense of share-based compensation due to the adoption of SFAS 123(R), a $452,000 increase in payments to our business partners, and a $298,000 increase in office and depreciation expense. Our brand advertising gross margin for the three and six months ended June 30, 2006 was 71% and 72%, respectively, as compared to 75% and 76% for the corresponding periods in 2005, respectively. Our brand advertising gross margin decreased for the three months and six months ended June 30, 2006 mainly because of the required expensing of share-based compensation cost due to the adoption of SFAS 123(R) starting from January 1, 2006, and more spending on content purchases, personal costs and bandwidth leasing costs.

Sponsored search. Sponsored search cost of revenues consisted primarily of payments to our Website Alliance, data collection costs, personnel costs, relevant depreciation of servers and computer equipment and bandwidth leasing costs. Sponsored search cost of revenues was $1.2 million and $2.3 million for the three and six months ended June 30, 2006, respectively, as compared to $699,000 and $1.2 million for the corresponding three and six month periods in 2005. The increase of $500,000 in sponsored search cost of revenues for the three months ended June 30, 2006 as compared to the corresponding period in 2005 resulted from an increase of $282,000 in relevant depreciation and bandwidth leasing costs, an increase of $148,000 in payment to Website Alliances, the expensing of share-based compensation cost of $22,000 due to the adoption of SFAS 123(R) and an increase of $48,000 in other expenses. The increase of $1.1 million in sponsored search cost of revenues for the six months ended June 30, 2006 as compared to the corresponding period in 2005 resulted from an increase of $535,000 in relevant depreciation and bandwidth leasing costs, an increase of $366,000 in payment to Website Alliances, the expensing of share-based compensation cost of $44,000 due to the adoption of SFAS 123(R) and an increase of $155,000 in other expenses. Our sponsored search gross margin for the three and six months ended June 30, 2006 was 65% and 66%, respectively, as compared to 77% and 80% for the corresponding periods in 2005, respectively. Our sponsored search gross margin decreased for the three months and six months ended June 30, 2006 mainly due to increased server depreciation and bandwidth leasing costs.

Non-advertising Cost of Revenues

Non-advertising cost of revenues were $5.3 million and $9.9 million for the three and six months ended June 30, 2006, respectively, as compared to $3.5 million and $6.5 million for the corresponding three and six month periods in 2005.

Wireless. Wireless cost of revenues increased by $1.6 million to $4.5 million for the three months ended June 30, 2006, and increased by $3.1 million to $8.3 million for the six months ended June 30, 2006, as compared to the corresponding three and six month periods in 2005. Wireless cost of revenues mainly consists of collection and wireless transmission charges paid to mobile network operators, expenses related to complaints based on allegations for the breach of certain provisions of agreements with mobile network operations, fees or royalties paid to third party content providers for services and content associated with our wireless services, relevant depreciation of servers and computer equipment and bandwidth leasing costs. Our wireless gross margins were 50% and 51% for the three and six months ended June 30, 2006, respectively, as compared to 55% and 58% for the corresponding periods in 2005. Wireless gross margin for the six months ended June 30, 2006

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decreased compared to the corresponding period in 2005 primarily because of the reduced price ceiling set by a mobile network operator on SMS fees and increased wireless content expenses.

Others. Cost of revenues for other services, was $826,000 and $1.6 million for the three and six months ended June 30, 2006, respectively, as compared to $675,000 and $1.3 million for the corresponding three and six month periods in 2005. Cost of revenues for other services mainly consists of payments to game developers. Following the acquisition of Go2Map, cost of other revenues also includes personnel and other expenses in connection with sale of software business and provision of ASP services. For the three and six months ended June 30, 2006, the cost of sales of software and provision of ASP services was $105,000 and $176,000, respectively, as compared to $44,000 for the period from May 31, 2005, the acquisition date of Go2Map, to June 30, 2005.

Product Development Expenses

Product development expenses increased by $1.0 million to $4.6 million for the three months ended June 30, 2006, and increased by $2.2 million to $8.9 million for the six months ended June 30, 2006, as compared to the corresponding three and six month periods in 2005. The increase for the three months ended June 30, 2006 from the corresponding period in 2005 was due to a $888,000 increase in personnel expenses resulting from an increase in headcount and salary increment and $369,000 of the required expensing of share-based compensation cost under SFAS 123(R), which amounts were offset by a decrease in other expenses of $257,000. The increase for the six months ended June 30, 2006 from corresponding period in 2005 was primarily due to a $1.5 million increase in personnel expenses resulted from an increase in headcount and salary increment and $863,000 of the required expensing of share-based compensation cost under SFAS 123(R), which amounts were offset by a $163,000 decrease in other expenses.

Sales and Marketing Expenses

Sales and marketing expenses increased by $3.0 million to $7.0 million for the three months ended June 30, 2006, and increased by $5.0 million to $13.4 million for the six months ended June 30, 2006, as compared to the corresponding three and six month periods in 2005. The increase for the three months ended June 30, 2006 from the corresponding period in 2005 was primarily due to a $1.2 million increase in advertising and promotion expense, which included the relevant expenses associated with our exclusive Olympic sponsorship in the Internet Content Services category and our exclusive rights to provide 2006 FIFA World Cup online video content, a $540,000 increase in personnel expenses resulted from increases in headcount and salary increment, a $422,000 increase in bad debt expense, $298,000 of the required expensing of share-based compensation cost under SFAS 123(R), a $241,000 increase in depreciation and facilities expenses, a $151,000 increase in traveling and entertainment expenses, and a $148,000 increase in other expenses. The increase for the six months ended June 30, 2006 from corresponding period in 2005 primarily consisted of a $2.1 million increase in advertising and promotion which included the relevant expenses associated with our exclusive Olympic sponsorship in the Internet Content Services category and our exclusive rights to provide 2006 FIFA World Cup online video content, a $1.2 million increase in personnel expenses resulted from increases in headcount and salary increment, $746,000 of the required expensing of share-based compensation cost under SFAS 123(R), a $455,000 increase in depreciation and facilities expenses, a $271,000 increase in traveling and entertainment expenses and a $228,000 increase in other expenses.

General and Administrative Expenses

General and administrative expenses increased by $0.8 million to $3.2 million for the three months ended June 30, 2006, and increased by $1.4 million to $6.3 million for the six months ended June 30, 2006, as compared to the corresponding three and six month periods in 2005. The increase for the three months ended June 30, 2006 from corresponding period in 2005 was primarily due to a $342,000 increase in personnel expenses, $313,000 of the required expensing of share-based compensation cost under SFAS 123(R) and a

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$145,000 increase in other expenses. The increase for the six months ended June 30, 2006 from corresponding period in 2005 was primarily due to a $919,000 increase in personnel expenses, $737,000 of the required expensing of share-based compensation cost under SFAS 123(R) and a $256,000 decrease in other expenses.

Amortization of Intangible Assets

Amortization of intangible assets were $509,000 and $1.0 million for the three and six months ended June 30, 2006, respectively, as compared to $474,000 and $930,000 for the three and six months ended June 30, 2005, which were related to the acquisitions of the 17173.com, Focus.cn, Goodfeel and Go2Map.

Operating Profit

As a result of the foregoing, our operating profit decreased by $0.3 million to $6.6 million for the three months ended June 30, 2006, and increased by $0.2 million to $12.8 million for the six months ended June 30, 2006, as compared to the corresponding three and six month periods in 2005. The operating profit for the three and six months ended June 30, 2006 included $1.3 million and $3.0 million, respectively, for share-based compensation expense recorded under SFAS 123(R). The operating profit for the three and six months ended June 30, 2005 included $0 and $2,000, respectively, for share-based compensation expense recorded under APB 25.

Other Income (Expenses)

For the three and six months ended June 30, 2006, other income of $711,000 and $643,000 mainly consisted of $793,000 of income from early redemption of zero coupon convertible senior notes. For the three and six months ended June 30, 2005, other expenses of $92,000 and $262,000 mainly consisted of $187,000 and $374,000 of amortization of the offering cost of our zero coupon convertible senior note issued in July 2003.

Interest Income

For the three and six months ended June 30, 2006, interest income was $787,000 and $1.3 million, as compared to $555,000 and $1.1 million for the three and six months ended June 30, 2005, mainly due to the changes in market interest rates.

Income Tax Expense

For the three and six months ended June 30, 2006, income tax expense was $303,000 and $746,000, as compared to $50,000 and $112,000 for the three and six months ended June 30, 2005. The increase was because some of our major operating subsidiaries and VIEs are now subject to an applicable income tax rate of 7.5% starting from January 1, 2006.

Most of our income is earned in China by Sohu Era, Sohu Internet, Sogou Technology and Sogou Information. As new technology enterprises, Sohu Era and Sohu Internet are exempted from income tax for the years ended December 31, 2003, 2004 and 2005, are subject to a 7.5% tax rate for the years ending December 31, 2006, 2007 and 2008, and are subject to a 15% tax rate for each year thereafter. Sogou Technology and Sogou Information are exempted from income tax for the years ended December 31, 2006, 2007 and 2008, are subject to a 7.5% tax rate for the years ending December 31, 2009, 2010 and 2011, and are subject to a 15% tax rate for each year thereafter. If Sohu Era, Sohu Internet, Sogou Technology and Sogou Information and do not continue to meet the definition of a new technology enterprise or there are changes in the taxation policies of the PRC government, their income would be subject to taxation at the rate of 33%.

Income earned in the United States, where Sohu.com Inc. is incorporated, is subject to taxation at 34% or 35%. For the foreseeable future, we anticipate the major source of income earned in the United States and subject to United States taxation to be interest income. If dividends are paid by our China or other non-U.S. subsidiaries

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to Sohu.com Inc., the dividends would be taxed at Sohu.com Inc. s rate of taxation which is 34% or 35% (as reduced by any applicable deemed-paid foreign tax credits for foreign income taxes paid by such subsidiaries). For the foreseeable future, we do not intend for the China or other non-U.S. subsidiaries to pay dividends to Sohu.com Inc.

Income from Continuing Operations

For the three and six months ended June 30, 2006, income from continuing operations was $7.8 million and $14.0 million, as compared to $7.3 million and $13.3 million for the three and six months ended June 30, 2005.

Loss from Discontinued E-commerce Operations

In June 2006, we discontinued our e-commerce business. For the three and six months ended June 30, 2006, loss from discontinued e-commerce operations was $592,000 and $757,000, as compared to $210,000 and $496,000 for the three and six months ended June 30, 2005. The increase of loss from discontinued e-commerce operations is due to additional provisions made for receivables and inventories for e-commerce business when we discontinued the business in June 2006. At the discontinuance of e-commerce operation, we had performed a specific review on all the assets related to e-commerce segment. During the three months ended June 30, 2006, we provided an additional allowance for doubtful receivables amounting to $154,000, and allowance on all inventory balances amounting to $134,000. As the fixed assets previously used by the e-commerce operation could generally be used by other segments, we did not dispose significant fixed assets nor provide impairment on the fixed assets.

Net Income

As a result of the foregoing, we had net income of $7.2 million and $13.2 million for the three and six months ended June 30, 2006, as compared to net income of $7.1 million and $12.8 million for the three and six months ended June 30, 2005. The net income for the three and six months ended June 30, 2006 included $1.3 million and $3.0 million of share-based compensation expense recorded under SFAS 123(R). The net income for the three and six months ended June 30, 2005 included $0 and $2,000 of share-based compensation expense recorded under APB 25.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations and capital expenditures principally through private sales of equity securities, the initial public offering of our common stock, a private placement of zero coupon convertible senior notes, and cash provided by operations. From inception through June 30, 2006, we have raised net proceeds of $39.2 million through the sale of preferred stock in private placements, $52.4 million from the sale of common stock in our initial public offering and $87.4 million through the sale of zero coupon convertible senior notes.

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

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addition, upon a change of control event, each holder of the notes may require Sohu to repurchase some or all of its notes at a repurchase price equal to 100% of the principal amount of the notes. During the three months ended June 30, 2006, we have early redeemed a portion of our zero coupon convertible senior notes from the market at a discount for $15,000,000 in aggregate face value. As of June 30, 2006, total face value of outstanding zero coupon convertible senior notes was $59,780,000.

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

	Six months ended June 30,	
	2006	2005
Net cash provided by operating activities	$ 15,655	$ 11,527
Net cash used in investing activities	(4,871)	(12,838)
Net cash used in financing activities	(11,638)	(11,955)
Effect of exchange rate change on cash and cash equivalents	781	
Net decrease in cash and cash equivalents	(73)	(13,266)
Cash and cash equivalents at beginning of period	119,091	122,384
Cash and cash equivalents at end of period	$ 119,018	$ 109,118

For the six months ended June 30, 2006, net cash provided by operating activities was $15.7 million, and was primarily attributable to our net income of $13.2 million, depreciation and amortization of $4.7 million, share-based compensation of $3.0 million, provision for allowance for doubtful accounts of $756,000, which were offset by gains on early redemption of zero coupon convertible senior notes of $793,000 and net changes in current assets and liabilities of $5.4 million. For the six months ended June 30, 2005, net cash provided by operating activities was $11.5 million, and was primarily attributable to our net income of $12.8 million, depreciation and amortization of $4.1 million, and provision for allowance for doubtful accounts of $640,000, which were offset by net changes in current assets and liabilities of $6.2 million.

For the six months ended June 30, 2006, net cash used in investing activities was $4.9 million, and was primarily attributable to $4.6 million used in purchasing fixed assets and other assets, and $306,000 spent on acquisition. For the six months ended June 30, 2005, net cash used in investing activities was $12.8 million, and was primarily attributable to $9.8 million in cash used in connection with acquisition of Go2Map and $5.8 million in cash used to purchase fixed assets and other assets, which amount was partially offset by $3.1 million received as a result of the maturities of marketable debt securities.

For the six months ended June 30, 2006, net cash used in financing activities was $11.6 million, and was primarily attributable to $14.1 million used in early redemption of zero coupon convertible senior notes partially offset by $2.4 million cash collection from issuance of common stock upon the exercise of options granted under our stock incentive plan. For the six months ended June 30, 2005, net cash used in financing activities was $12.0 million, and was primarily attributable to $13.8 million used for the repurchase of our common stock. This amount was partially offset by $1.9 million received from the issuance of common stock upon the exercise of options granted under our stock incentive plan.

As of June 30, 2006, we had cash and cash equivalents of $119.0 million, and investments in marketable debt securities of $13.9 million, totaling approximately $132.9 million as compared to $133.1 million as of December 31, 2005.

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

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RISK FACTORS

Risks Related to Our Business

We are a relatively young company subject to the risks associated with operating in a new and evolving market.

As a relatively young company in the new and rapidly evolving PRC Internet market, we face numerous risks and uncertainties. Some of these risks relate to our ability to:

- continue to attract a larger audience to our matrices of Web properties and proprietary search engines by expanding the type and technical sophistication of the content and services we offer;
- maintain our current, and develop new, strategic relationships to increase our revenue streams as well as product and service offerings;
- increase the revenues derived from our fee-based services and products we offer online;
- build our sponsored search, wireless, and online games businesses successfully; and
- attract and retain qualified personnel.

Our operating results are likely to fluctuate significantly and may differ from market expectations.

Our annual and quarterly operating results have varied significantly in the past, and may vary significantly in the future, due to a number of factors which could have an adverse impact on our business, such as our reliance on advertisers in certain industries for brand advertising revenues, our reliance on certain key third party distributors for sponsored search revenues and our reliance on mobile network operators for our wireless revenues. The Chinese Internet industry is in an early stage of development and we are unsure if it will continue to grow or at what rate it will grow, and we are subject to government regulations that may change at any time with or without notice. Fluctuations in the industries of our key advertisers may affect our brand advertising revenues materially, because they may cut their spending on online marketing if there is any downturn in their industries. We rely on certain third party distributors to sell our sponsored search products. If we lose any of our key distributors, our business may be materially affected. We rely on mobile network operators for, among other things, billing of and collection of wireless service fees from mobile phone users. If our arrangements with the operators were to be terminated, altered or not renewed, or if the operators did not provide continuous or adequate service, our wireless revenues could be reduced significantly.

As a result, we believe that year-to-year and quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. In addition, we have experienced very high growth rates in certain business lines in the past and there may be expectations that these growth rates will continue. In the past, our operating results have sometimes fallen below the expectations of public market analysts and investors, and they may do so again in the future. In this event, the trading price of our common stock may fall.

We face intense competition which could reduce our market share and adversely affect our financial performance.

There are many companies that distribute online content and services targeting Chinese users. We compete with distributors of content and services over the Internet, including Web directories, search engines, content sites, Internet service providers and sites maintained by government and educational institutions. These sites compete with us for visitor traffic, advertising dollars, wireless services, online game users and potential partners. The Internet market in China is relatively new and rapidly evolving. Competition is intense and is expected to increase significantly in the future because there are no substantial barriers to entry in our market.

We have many competitors in the PRC Internet market, including Sina, Netease, Tencent, Baidu, Tom Online, KongZhong, Linktone, Shanda, Google and Yahoo! China. In addition, there are a number of existing or

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new PRC Internet portals, including those controlled or sponsored by PRC government entities. These private and government sponsored competitors may have certain competitive advantages over us in terms of:

- substantially greater financial and technical resources;
- more extensive and well developed marketing and sales networks;
- better access to original content and information;
- greater global brand recognition among consumers; and
- larger customer bases.

We compete with other portals in China primarily on the following basis:

- attractiveness of products;
- brand recognition;
- volume of traffic and users;
- quality of our Websites and content;
- strategic relationships;
- quality of our services;
- effectiveness of sales and marketing efforts;
- talented staff; and
- price.

Our existing competitors may in the future achieve greater market acceptance and gain additional market share. It is also possible that new competitors may emerge and acquire significant market share. In particular, our search engine faces intense competition from software and other Internet products and services incorporating search and retrieval capabilities, such as Baidu, Google and Yahoo! China. In addition, operators of leading Websites or Internet service providers, including Yahoo!, Microsoft/MSN and America Online, currently offer, and could expand, their online products and services targeting China. We believe the rapid increase in China s online population will draw more attention from these

multinational players to the PRC Internet market. We also compete with traditional forms of media, such as newspapers, magazines, radio and television, for advertisers and advertising revenues.

If we fail to successfully develop and introduce new products and services, our competitive position and ability to generate revenues could be harmed.

We are continuously developing new products and services for our users. The planned timing or introduction of new products and services is subject to risks and uncertainties. Actual timing may differ materially from original plans. Unexpected technical, operational, distribution or other problems could delay or prevent the introduction of one or more of our new products or services. Moreover, we cannot be sure that any of our new products and services will achieve widespread market acceptance or generate incremental revenue.

Our business depends on a strong brand, thus we will not be able to attract users, customers and clients of our products and offerings if we do not maintain and develop our brands.

It is critical for us to maintain and develop our brands so as to effectively expand our user base and our revenues. We believe that the importance of brand recognition will increase as the number of Internet users in China grows. In order to attract and retain Internet users, advertisers, wireless, and online games customers, we may need to substantially increase our expenditures for creating and maintaining brand loyalty. Accordingly, our revenues will need to increase at least proportionately, in order for us to maintain our current levels of profitability.

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Our success in promoting and enhancing our brands, as well as our ability to remain competitive, will also depend on our success in offering high quality content, features and functionality. If we fail to promote our brands successfully or if visitors to our Websites or advertisers do not perceive our content and services to be of high quality, we may not be able to continue growing our business and attracting visitors, advertisers, wireless, and online game customers.

Our failure to keep up with rapid technology changes may severely affect our future success.

The Internet industry is undergoing rapid technological changes. Our future success will depend on our ability to respond to rapidly evolving technologies, adapt our services to changing industry standards and improve the performance and reliability of our services. If we fail to adapt to such changes, our business may be adversely affected. For example, with the evolution of Web 2.0, Internet users may shift to new modes of information sharing, such as blogs. With the development of search engine technologies, Internet users may choose to access information, news and contents through search engines rather than portals. In addition, with the development of 2.5G and even 3G technology, the focus of wireless applications has been transferred from text message services to multi-media message services, wireless games, wireless downloads and other applications. Accordingly, we will need to adapt our business to cope with the changes and support these new services to be successful. In addition, the online games industry is evolving rapidly, so we will need to anticipate new technologies and games and evaluate their possible market acceptance. We may be unable to recover our game development costs if new technologies render our online games less attractive to users.

We depend on online advertising for a significant portion of our revenues, but the online advertisement market includes many uncertainties, which could cause our advertising revenues to decline.

We derive a significant portion of our revenues, and expect to derive a significant portion of our revenues for the foreseeable future, from the sale of advertising on our Websites. Advertising revenues represented approximately 67% and 67% of our total revenues for the six months ended June 30, 2006 and 2005, respectively. For the six months ended June 30, 2006 and 2005, our five largest advertisers accounted for approximately 17% and 16% of our total brand advertising revenues, respectively. The growth of our advertising revenues relies on increased revenue from the sale of advertising spaces on our Websites, which may be affected by many risk factors as follows:

The online advertising market is new and rapidly evolving, particularly in China. As a result, many of our current and potential advertising clients have limited experience using the Internet for advertising purposes and historically have not devoted a significant portion of their advertising budget to Internet-based advertising.

Advertising clients that have invested substantial resources in other methods of conducting business may be reluctant to adopt a new strategy that may limit or compete with their existing efforts.

The acceptance of the Internet as a medium for advertising depends on the development of a measurement standard. No standards have been widely accepted for the measurement of the effectiveness of online advertising. Industry-wide standards may not develop sufficiently to support the Internet as an effective advertising medium. If these standards do not develop, advertisers may choose not to advertise on the Internet in general or through our portals or search engines.

In addition, our ability to generate and maintain significant online advertising revenues will also depend upon:

the development of a large base of users possessing demographic characteristics attractive to advertising clients;

the acceptance of online advertisement as an effective way for business marketing by advertising clients;

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the effectiveness of our advertising delivery, tracking and reporting systems; and

the resistance pressure on online advertising prices and limitations on inventory.

The expansion of Internet advertisement blocking software may result in a decrease of advertising revenues.

The development of Web software that blocks Internet advertisements before they appear on a user s screen may hinder the growth of online advertising. The expansion of advertisement blocking on the Internet may decrease our revenues because when an advertisement is blocked, it is not downloaded from our advertisement server. As a result, such advertisements will not be tracked as a delivered advertisement. In addition, advertisers may choose not to advertise on the Internet or on our Websites because of the use by third parties of Internet advertisement blocking software.

Our failure to retain key distributors or attract additional distributors for our sponsored search customers could have an adverse impact on our business.

Sponsored search is at an early stage of development in China and is not as widely accepted by or available to businesses in China as in the United States. As a result, we rely heavily on our nationwide distribution network of third-party distributors for our sales to, and collection of payment from, our sponsored search customers. If our distributors do not provide quality services to our customers or otherwise breach their contracts with them, we may lose customers. We do not have long-term agreements with any of our distributors, including our key distributors, and cannot assure that we will continue to maintain favorable relationships with them.

We rely on our Website Alliance members for a significant portion of our sponsored search revenues. If we fail to retain existing Website Alliance members or attract additional members, our revenues and growth may be adversely affected.

By posting bid listing links on their Websites, we share with our Website Alliance members the revenues generated from clicks by users. For the quarter ended June 30, 2006, the total revenues generated from Website Alliance accounted for 75% of our total bid listing revenues. We consider our Website Alliance critical to the future growth of our revenues. If our Website Alliance members decide to use a competitor s or their own Internet search services, or if we fail to attract additional Websites to join our Website Alliance, our sponsored search revenues may decline.

We rely on wireless services for a significant portion of our revenues. Wireless revenues decreased in prior periods and may decrease further in the future.

We derive a significant portion of our revenues from wireless services. We derived our wireless revenues in prior periods from providing to mobile phone and Personal Handy-phone System (or PHS) users SMS, WAP, MMS, RBT and IVR, mainly consisting of news, weather forecast, chatting, entertainment information, ring tone, music, picture and logo downloads and various other mobile related products provided to mobile phone users. For the quarters ended June 30, 2006 and 2005, wireless revenues represented approximately 26% and 25%, respectively, of our total revenues. Wireless revenues decreased in certain prior periods. Wireless revenues may decrease in the future due to the possibilities that:

Our consumers may not understand our services or the fees they are being charged, may not be satisfied with our services and/or may not use our services on a regular basis;

Consumers may cancel their services at any time without notice;

Revenues from new wireless services such as WAP, MMS, RBT and IVR may not continue to grow significantly and become a significant portion of our total wireless revenues;

Competitors, including mobile network operators, may launch competing or better products than ours at any time;

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There are limited barriers to entry to the wireless services sector;

Changes in government policy could restrict or curtail the services which we provide;

Changes in the billing practices or operation rules and procedures of any of the four mobile network operators, namely CMCC, Unicom, China Netcom Communication Corporation (or China Netcom) and China Telecom Corporation (or China Telecom), on whom we rely for service delivery and fee collection, could have a material impact on our wireless revenue. In July 2006, two major mobile network operators, CMCC and Unicom, introduced new policies on wireless value-added services including extension of trial period, double reminders for new monthly subscriptions, billing reminders to existing monthly subscribers and conversion of per message-based SMS subscription to monthly subscriptions. We believe that our wireless revenues will be adversely affected by the implementation of the new policies;

Mobile network operators may impose penalties on wireless service providers, or SPs, for violating certain operating policies relating to the provision of wireless services. We have received several penalty notices from mobile network operators, claiming our breach of cooperation contracts and imposing both service suspension sanctions for a period of not more than a year and/or monetary penalties. There is no guarantee that we will not be subject to similar, or more severe penalties from mobile network operators in the future, which could significantly impair our wireless business;

We may enter into cooperation agreements with the mobile network operators, on terms that are not favorable to us since we have limited bargaining power to negotiate contract terms. In addition, mobile network operators may unilaterally revise their agreement at any time. As a result of such contract terms, we could be easily found in breach of our agreement with an operator and could be subject to penalties; and

Mobile network operators may not enter into new agreements or renew existing agreements with SPs with respect to wireless services. However, those mobile network operators will continue to work with us to provide services and monthly statements. New or renewed agreements with mobile network operators could change in a way that would be unfavorable to us, or such agreements may not be entered into at all.

We rely on contracts with the mobile network operators in a number of ways with respect to our wireless services, including billing of, and collection from, mobile phone users of wireless service fees. If our arrangements with mobile network operators were to be terminated, altered or not renewed, or if such operators did not provide continuous or adequate service, our revenues could be reduced.

Our wireless services depend mainly on the cooperation of mobile network operators such as CMCC, Unicom, China Netcom, China Telecom and their respective subsidiaries. We rely on mobile network operators in the following ways:

we use mobile network operators networks and gateways to provide wireless services;

we use and rely on mobile network operators billing systems to charge our subscribers through the subscribers mobile phone bills;

we rely on mobile network operators collection proxy services to collect payments from subscribers; and

we rely on mobile network operators infrastructure to further develop our wireless services.

We face significant risks with respect to our arrangements with mobile network operators, such as the following, which could adversely affect our wireless revenues:

Mobile network operators have changed their operating rules and may make further changes at any time. Such previous or any future changes could result in our being required to pay penalties for breaching or being alleged to have breached certain provisions of our agreements with the mobile network operators under new or revised operation rules, or having our service discontinued with or without notice. Changes in these operating rules could also have a material impact on our revenues;

We provide wireless services through our Website and record the delivery of the service in our internal systems. However, in order to recognize revenues and receive payment for services provided, we rely on billing confirmations from mobile network operators as to the actual amount of services they have billed to their mobile customers. We are unable to collect wireless service fees from an operator in certain circumstances due to technical issues with the operator s network. We refer to these failures as an operator s failure rate, which can vary from operator to operator. An operator s failure rate can vary from month to month, ranging from 0% to 98% and may change at any time without notice. If an operator encounters technical problems, increases in the failure rate for that operator could occur;

The service fees we pay for using an operator s infrastructure are set based on the negotiation of annual contracts. Our negotiation leverage is limited and if an operator increases its service fees, or does not comply with the terms of our contract, our gross margin and profitability could be materially reduced. Based on recent communications with an operator, certain subsidiaries of the operator are considering increasing their service fees;

We are required to follow the operators guidance in setting up wireless service fees. We also rely on the mobile network operators to collect the fees on our behalf which they have billed to our mobile customers. If an operator requires us to reduce the wireless service fees charged to mobile customers, disallows us from billing of certain inactive customers, refuses to pay us, or, limits the amount of wireless service fees which can be billed or requires us to comply with any new billing rules, our revenues could be adversely affected;

An operator s refusal to allow us to supply certain services could disrupt our wireless services. For example, for the period from September 1, 2004 to July 31, 2005, our MMS services were temporarily suspended by CMCC, based on allegations that Beijing Sohu breached certain provisions of its agreement with a CMCC subsidiary;

An operator could launch competing services at any time and could work with content providers directly so that SPs abilities to diversify their products might be limited. For example, in July 2006, CMCC introduced M.Music, an integrated music service platform which CMCC works directly with music record companies to provide downloads of various songs and music. If mobile network operators were unwilling to work with us, we would not be able to find substitute partners; and

CMCC set up rules for ranking of WAP service providers on its Monternet browser, which has a significant impact on WAP revenues. CMCC may change the rules at any time to affect the rank of the top five listings. As a result, the growth of our WAP revenues was lower than expected and we may lose our first position because of lower visit rates.

Many of our current and potential wireless customers have only limited experience using the Internet for subscription purposes, and may not be willing to fully embrace the products and services we offer, which would adversely affect our future revenues and business expansion.

The wireless market is new and rapidly evolving in China. Many of our current and potential wireless customers have limited experience using the Internet for subscription services. The growth in our wireless revenues depends upon user acceptance of our existing and new services, such as our wireless dating, e-mail, news, sports and jokes content, mobile alumni club and other products. Because these services are new and untested, we do not have a clear understanding of consumer behavior, making it difficult to predict future growth or usage. Customers may not be willing to fully embrace the products and services we offer.

Our investment in online games businesses may not be successful.

We have invested and may invest further in our online games businesses. Online game is currently one of the fastest growing online services in the PRC. We currently rely on licenses from third party game companies. Our licenses of Knight Online and Blade Online will expire in November 2006 and September 2007, respectively. In the event that a license expires and we wish to renew such license, the licensor may only agree to renew such license upon an increase in the license fee that we pay to such licensor. In addition, our business might be significantly affected if there are any changes in the PRC laws or regulations in relation to these

businesses. For example, the PRC government has issued a new law to implement restrictions and further regulation on the online games industry. Based on these rules, online games companies are required to install an anti-fatigue system , which discourages the game participants from playing games for more than five hours per day. In addition, it is possible that the PRC government will make a compulsory requirement for online game users to register their real names and provide ID numbers when playing games. Also, upon the requirement of the real name registration for online game users, the government will implement a rating system for online games. For those online games rated as not suitable for child under 18, such child will be not able to access the game if a real name registration is in place. As a result, our revenues from online games may be adversely affected. We may not succeed in these markets despite our investment of time and funds. If we fail to achieve a significant market position, we will fail to realize our anticipated returns on these investments.

Our strategy of acquiring complementary assets, technologies and businesses may fail and result in equity or earnings dilution.

As a component of our growth strategy, we have acquired and intend to actively identify and acquire assets, technologies and businesses that are complementary to our existing portal business. Our acquisitions could result in the use of substantial amounts of cash, potentially dilutive issuances of equity securities, significant impairment losses related to goodwill or amortization expenses related to intangible assets and exposure to undisclosed or potential liabilities of acquired companies. Moreover, the resources expended in identifying and consummating acquisitions may be significant. Furthermore, any acquisition we decide to pursue may be subject to the approval of the relevant PRC governmental authorities, as well as any applicable PRC rules and regulations. Considering the fast changing legal environment, our acquisition may be subject to government s further scrutiny and the acquisition structures we used to adopt may be found to be inappropriate.

The acquisition and integration of Goodfeel and Go2Map create certain risks and uncertainties.

We completed the acquisitions of Goodfeel in May 2004 and the acquisition of all of the outstanding capital stock of Go2Map Inc., and all of the registered share capital of Tu Xing Tian Xia, a company incorporated in the PRC which was an affiliate of Go2Map Inc. (collectively Go2Map) in May 2005. As a result of these acquisitions, we continue to spend considerable time and effort in integrating into our company the employees, organization, customers and operations of Goodfeel and Go2Map. Also, there can be no assurance that we will succeed in realizing the anticipated economic benefits of the acquisitions, including increased wireless and search revenues. During the three months ended June 30, 2006, Go2Map was operating at a loss. In addition, we might be required to obtain additional licenses or approvals from relevant government authorities based on the application laws and regulations and might incur additional costs and expenses in obtaining any such licenses and approvals.

We may be required to record a charge to earnings if impairment is determined when we reassess our goodwill or amortizable intangible assets arising from acquisitions.

We are required under generally accepted accounting principles to review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization, and slower growth rates in our industry. We may be required to record a charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined. As of June 30, 2006, our goodwill and amortizable intangible assets arising from acquisitions were approximately $61 million.

Changes in accounting rules for share-based compensation may adversely affect our operating results, our stock price and our competitiveness in the employee marketplace.

Our performance is largely dependent on talented and highly skilled individuals. Our future success depends on our continuing ability to identify, develop, motivate and retain highly skilled personnel for all areas of our organization. We have a history of using employee stock options to align employees interest with the interests of our shareholders and encourage quality employees to join us and retain our quality employees by providing competitive compensation packages. On January 1, 2006, we adopted SFAS 123(R) which requires the measurement and recognition of compensation expense for all share-based compensation based on estimated fair values. As a result, our operating results contain a charge for share-based compensation expense related to employee stock options and employee stock purchases. The recognition of share-based compensation in our statement of operations would have a negative effect on our reported results and earnings per share, which could in turn negatively affect our stock price. On the other hand, if we alter our employee stock option scheme to minimise the share-based compensation expenses, it may limit our ability to continue to use stock options as a tool to attract and retain our employees, and it may adversely affect our operations.

Our failure to manage growth and diversify our business could harm us.

We have experienced dramatic growth in personnel since our inception and we expect to continue to hire additional personnel in selected areas. This growth requires significant time and resource commitments from us and our senior management. If we are unable to effectively manage a large and geographically dispersed group of employees or anticipate our future growth, our business could be adversely affected.

Additionally, our business relies on our financial reporting and data systems (including our systems for billing users of our fee-based services), which have grown increasingly complex in the recent past due to acquisitions and the diversification and complexity of our business. Our ability to operate our business efficiently depends on these systems and if we are unable to adapt to these changes, our business could be adversely affected.

If we fail to establish and maintain relationships with content and technology providers and mobile network operators, we may not be able to attract and retain users.

We rely on a number of third party relationships to attract traffic and provide content in order to make our Websites more attractive to users and advertisers. Most of our arrangements with content providers are short-term and may be terminated at the convenience of the other party. Some content providers have increased the fees they charge us for their content. This trend could increase our costs and operating expenses and could adversely affect our ability to obtain content at an economically acceptable cost. We have also entered into exclusive agreements with some of our premier content providers. If we are not able to renew our exclusive deals or premier content become exclusive to our competitors, our attractiveness to users will be severely impaired. Except for the exclusive content, much of the third party content provided to our Websites is also available from other sources or may be provided to other Internet companies. If other Internet companies present the same or similar content in a superior manner, it would adversely affect our visitor traffic.

Our business also depends significantly on relationships with leading technology and infrastructure providers and the licenses that the technology providers have granted to us. Our competitors may establish the same relationships as we have, which may adversely affect us. We may not be able to maintain these relationships or replace them on commercially attractive terms.

We depend on key personnel and our business may be severely disrupted if we lose the services of our key executives and employees.

Our future success is heavily dependent upon the continued service of our key executives, particularly Dr. Charles Zhang, who is the founder, Chief Executive Officer, Chairman of the Board, and a major shareholder

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of our company and of the direct and indirect majority shareholder of Beijing Sohu, High Century, Sohu Internet, Tu Xing Tian Xia and Feng Yang Tian Lang. We rely on his expertise in our business operations, and on his personal relationships with the relevant regulatory authorities, our customers and suppliers. If one or more of our key executives and employees are unable or unwilling to continue in their present positions, we may not be able to replace them easily and our business may be severely disrupted. In addition, if any of our key executives or employees joins a competitor or forms a competing company, we may lose customers and suppliers and incur additional expenses to recruit and train personnel. Each of our executive officers has entered into an employment agreement and a confidentiality, non-competition and non-solicitation agreement with us. However, the degree of protection afforded to an employer pursuant to confidentiality and non-competition undertakings governed by PRC law may be more limited when compared to the degree of protection afforded under the laws of other jurisdictions. We do not maintain key-man life insurance for any of our key executives.

We also rely on a number of key technology staff for the operation of Sohu. Given the competitive nature of the industry, the risk of key technology staff leaving Sohu is high and could have a disruptive impact on our operations.

Rapid growth and a rapidly changing operating environment strain our limited resources.

We have limited operational, administrative and financial resources, which may be inadequate to sustain the growth we want to achieve. As the demands of our audience and the needs of our customers change and as the number of our users and volume of online advertising, and wireless activities increase, we will need to increase our investment in our network infrastructure, facilities and other areas of operations. If we are unable to manage our growth and expansion effectively, the quality of our services could deteriorate and our business may suffer. Our future success will depend on, among other things, our ability to:

- adapt our services and maintain and improve the quality of our services;
- protect our Website from hackers and unauthorized access;
- continue training, motivating and retaining our existing employees and attract and integrate new employees; and
- develop and improve our operational, financial, accounting and other internal systems and controls.

Risks Related to China s Telecommunications Infrastructure

The telecommunications infrastructure in China, which is not as well developed as in the United States, may limit our growth.

The telecommunications infrastructure in China is not well developed. Our growth will depend on the PRC government and state-owned enterprises establishing and maintaining a reliable Internet and telecommunications infrastructure to reach a broader base of Internet users in China. The Internet infrastructure, standards, protocols and complementary products, services and facilities necessary to support the demands associated with continued growth may not be developed on a timely basis or at all by the PRC government and state-owned enterprises.

We depend on ChinaNet, China Netcom and China Telecom for telecommunications services, and any interruption in these services may result in severe disruptions to our business.

Although private Internet service providers exist in China, almost all access to the Internet is maintained through ChinaNet, currently owned by China Netcom and China Telecom, under the administrative control and regulatory supervision of the Ministry of Information Industry (or MII). In addition, local networks connect to the Internet through a government-owned international gateway. This international gateway is the only channel through which a domestic Chinese user can connect to the international Internet network. We rely on this infrastructure and China Netcom and China Telecom to provide data communications capacity primarily through local telecommunications lines. Although the government has announced aggressive plans to develop the

national information infrastructure, this infrastructure may not be developed and the Internet infrastructure in China may not be able to support the continued growth of Internet usage. In addition, we will have no access to alternative networks and services, on a timely basis if at all, in the event of any infrastructure disruption or failure.

We have signed Bandwidth Provision and Server Hosting Agreements with China Netcom and China Telecom. Under these agreements, we established two main service provision centers to maintain most of our servers in Beijing. However, as there are limited telecommunication infrastructure service providers, we may not be able to lease additional bandwidth on acceptable terms, on a timely basis, or at all. If we are not able to lease additional bandwidth, the development of our business can be affected.

The high cost of Internet access may limit the growth of the Internet in China and impede our growth.

Access to the Internet in China remains relatively expensive, and may make it less likely for users to access and transact business over the Internet. Unfavorable rate developments could further decrease our visitor traffic and our ability to derive revenues from transactions over the Internet.

To the extent we are unable to scale our systems to meet the increasing PRC Internet population, we will be unable to expand our user base and increase our attractiveness to advertisers and merchants.

As Web page volume and traffic increase in China, we may not be able to scale our systems proportionately. To the extent we do not successfully address our capacity constraints, our operations may be severely disrupted, and we may not be able to expand our user base and increase our attractiveness to advertisers and merchants.

Unexpected network interruptions caused by system failures may result in reduced visitor traffic, reduced revenue and harm to our reputation.

Our Website operations are dependent upon Web browsers, Internet service providers, content providers and other Website operators in China, which have experienced significant system failures and system outages in the past. Our users have in the past experienced difficulties due to system failures unrelated to our systems and services. Any system failure or inadequacy that causes interruptions in the availability of our services, or increases the response time of our services, as a result of increased traffic or otherwise, could reduce our user satisfaction, future traffic and our attractiveness to users and advertisers.

Our operations are vulnerable to natural disasters and other events, as we only have limited backup systems and do not maintain any backup servers outside of China.

We have limited backup systems and have experienced system failures and electrical outages from time to time in the past, which have disrupted our operations. Most of our servers and routers are currently hosted in a single location within the premises of Beijing Telecom Administration (or BTA). Our disaster recovery plan cannot fully ensure safety in the event of damage from fire, floods, typhoons, earthquakes, power loss, telecommunications failures, break-ins and similar events. If any of the foregoing occurs, we may experience a complete system shutdown. We do not carry any business interruption insurance. To improve the performance and to prevent disruption of our services, we may have to make substantial investments to deploy additional servers or one or more copies of our Websites to mirror our online resources.

Although we carry property insurance with low coverage limits, our coverage may not be adequate to compensate us for all losses, particularly with respect to loss of business and reputation, that may occur.

Our network operations may be vulnerable to hacking, viruses and other disruptions, which may make our products and services less attractive and reliable.

Internet usage could decline if any well-publicized compromise of security occurs. Hacking involves efforts to gain unauthorized access to information or systems or to cause intentional malfunctions or loss or

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corruption of data, software, hardware or other computer equipment. Hackers, if successful, could misappropriate proprietary information or cause disruptions in our service. We may be required to expend capital and other resources to protect our Website against hackers. We cannot assure you that any measure we may take will be effective. In addition, the inadvertent transmission of computer viruses could expose us to a material risk of loss or litigation and possible liability, as well as materially damage our reputation and decrease our user traffic.

Risks Related to China s Regulation Environment

If our current ownership structure is found to be in violation of existing or future PRC laws, rules or regulations regarding the legality of foreign investment in the PRC value-added telecommunication operations, we could be subject to severe penalties.

We conduct our value-added telecommunication operations solely in the PRC through our indirect wholly owned subsidiaries, Beijing ITC, Sohu Era, Sohu Software, Go2Map Software and Sogou Technology (or collectively PRC subsidiaries), and VIEs Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and Sogou Information (or collectively VIEs). We are a Delaware corporation, while Sohu Hong Kong, our indirect wholly owned subsidiary and the parent company of Beijing ITC, Sohu Era and Sohu Software is a Hong Kong corporation and a foreign person under PRC law. In order to meet ownership requirements under PRC law which restrict or prohibit wholly foreign owned enterprises, or WFOEs, from operating in certain industries such as Internet information, wireless, Internet access, and certain other industries, our VIEs are companies incorporated in the PRC and owned by Dr. Zhang and certain other employees of Sohu, rather than by Sohu.

The PRC began several years ago to regulate its Internet sector by making pronouncements or enacting regulations regarding the legality of foreign investment in the PRC Internet sector and the existence and enforcement of content restrictions on the Internet. We believe that our current ownership structure complies with all existing PRC laws, rules and regulations. There are, however, substantial uncertainties regarding the interpretation of current PRC value-added telecommunication operations laws and regulations. In addition, new PRC telecommunication and foreign exchange laws and regulations were recently adopted. Accordingly, it is possible that the PRC government may ultimately take a view contrary to ours.

In addition, under the agreement reached in November 1999 between the PRC and the United States concerning the United States support of China s entry into the World Trade Organization, or WTO, foreign investment in PRC Internet services are to be liberalized to allow for 30% foreign ownership in key telecommunication services, including PRC Internet ventures, for the first year after China s entry into the WTO, 49% in the second year and 50% thereafter. China officially entered the WTO on December 11, 2001. However, the implementation of China s WTO accession agreements is still subject to various conditions.

Accordingly, it is possible that the relevant PRC authorities could, at any time, assert that any portion or all of the Sohu PRC subsidiaries and Sohu VIEs existing or future ownership structure and businesses violate existing or future PRC laws, regulations or policies. It is also possible that the new laws or regulations governing the PRC telecommunication sector that have been adopted or may be adopted in the future will prohibit or restrict foreign investment in, or other aspects of, any of our PRC subsidiaries and VIEs current or proposed businesses and operations. In addition, any such new laws and regulations may be retroactively applied to us and our PRC subsidiaries and VIEs.

If we or any of our PRC subsidiaries and VIEs were found to be in violation of any existing or future PRC laws or regulations, the relevant PRC authorities would have broad discretion in dealing with such violation, including, without limitation, the following:

- levying fines;
- confiscating our income;

revoking our business licenses;

shutting down our servers and/or blocking our Websites;

requiring us to restructure its ownership structure or operations; and

requiring us to discontinue any portion or all of its Internet and value-added telecommunication businesses.

We may rely on dividends and other distributions on equity paid by Sohu.com Limited, our wholly owned subsidiary, to fund any cash requirements we may have. We may not be able to obtain cash from distributions to the extent such distributions are restricted by PRC law or future debt covenants. For any dividend received by Sohu.com Inc., it would be subject to US tax at 34% to 35%.

We are a holding company with no operating assets other than investments in Chinese operating entities, including Beijing ITC, Sohu Era, Sohu Software, Go2Map Software, Sogou Technology and Sohu New Media, through an intermediate holding company, Sohu.com Limited, our wholly-owned subsidiary in the Cayman Islands, and our VIEs, Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and Sogou Information. We may need to rely on dividends and other distributions on equity paid by Sohu.com Limited for our cash requirements in excess of any cash raised from investors and retained by us. If Beijing ITC, Sohu Era, Sohu Software, Go2Map Software, Sogou Technology and Sohu New Media incur debt on their own behalf in the future, the instruments governing the debt may restrict Beijing ITC s, Sohu Era s, Sohu Software s, Go2Map Software s, Sogou Technology s and Sohu New Media s ability to pay dividends or make other distributions to us. In addition, PRC legal restrictions permit payment of dividends by Beijing ITC, Sohu Era, Sohu Software, Go2Map Software, Sogou Technology and Sohu New Media only out of their net income, if any, determined in accordance with PRC accounting standards and regulations. Under PRC law, Beijing ITC, Sohu Era, Sohu Software, Go2Map Software, Sogou Technology and Sohu New Media are also required to set aside 10% of their net income each year to fund certain reserve funds until these reserves equal 50% of the amount of paid-in capital. These reserves are not distributable as cash dividends. Furthermore, dividends received by Sohu.com Inc. would be subject to taxation at United States tax rates of 34% or 35%. We do not expect any dividends or other distributions on equity from Sohu.com Limited in the foreseeable future.

We may be unable to collect long-term loans to officers and employees or exercise management influence associated with Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu and Sogou Information.

As of June 30, 2006, Sohu had outstanding long-term loans of $9.8 million to Dr. Zhang, Sohu s chief executive officer and a major Sohu shareholder, and certain of our employees. The long-term loans are used to finance investments in Beijing Sohu, which is owned 80% by Dr. Zhang and 20% by High Century, High Century, which is owned 80% by Dr. Zhang and 20% by an employee, Sohu Entertainment, which is owned by two of our employees, Goodfeel, which is owned by two of our employees, Huohu, which is owned 75% by Sohu Era and 25% by an employee; and Sogou Information, which is owned by two of our employees. Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu and Sogou Information are used to facilitate our participation in telecommunications, Internet content and certain other businesses in China where foreign ownership is either prohibited or restricted.

The agreements contain provisions that, subject to PRC law, (i) the loans can only be repaid to us by transferring the shares of Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu or Sogou Information to us; (ii) the shares of Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu or Sogou Information cannot be transferred without our approval; and (iii) we have the right to appoint all directors and senior management personnel of Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu and Sogou Information. Dr. Zhang and the other employee borrowers have pledged all of their shares in Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu and Sogou Information as collateral for the loans and the loans bear no interest and are due on demand after November 2003 in the case of High Century; after November 2005 in the case of Huohu; after August 12, 2006 in the case of Sogou Information; after October 2006 in the case of

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Goodfeel; after November 3, 2006 in the case of Sohu Entertainment and the earlier of a demand or 2010 in the case of Beijing Sohu; or, in any case, at such time as Dr. Zhang or the other employee borrowers, as the case may be, is not an employee of Sohu. Sohu does not intend to request repayment of the loans as long as PRC regulations prohibit it from directly investing in businesses being undertaken by the VIEs.

Because these loans can only be repaid by the borrowers transferring the shares of the various entities, our ability to ultimately realize the effective return of the amounts advanced under these loans will depend on the profitability of Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu and Sogou Information which is uncertain.

Furthermore, because of uncertainties associated with the PRC law, ultimate enforcement of the loan agreements is uncertain. Accordingly, we may never be able to collect these loans or exercise influence over Beijing Sohu, High Century, Sohu Entertainment, Goodfeel, Huohu and Sogou Information.

We depend upon contractual arrangements with Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and Sogou Information for the success of our business and these arrangements may not be as effective in providing operational control as direct ownership of these businesses and may be difficult to enforce.

Because we conduct our Internet operations only in the PRC, and are restricted or prohibited by the PRC government from owning Internet content or telecommunication operations in the PRC, we are dependent on Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and Sogou Information in which we have no direct ownership interest, to provide those services through contractual agreements between the parties. These arrangements may not be as effective in providing control over our Internet content or telecommunications operations as direct ownership of these businesses. For example, Beijing Sohu and Sohu Internet could fail to take actions required for our business, such as entering into content development contracts with potential content suppliers or failing to maintain the necessary permit for the content servers. If Beijing Sohu, High Century, Sohu Entertainment, Sohu Internet, Goodfeel, Huohu, Tu Xing Tian Xia, Feng Yang Tian Lang and/or Sogou Information fail to perform their obligations under these agreements, we may have to rely on legal remedies under PRC law. We cannot assure you that such remedies under PRC law would be effective or sufficient.

Dr. Zhang, our chief executive officer and a major shareholder of our company, is also the direct and indirect majority shareholder of Beijing Sohu, High Century, Sohu Internet, Tu Xing Tian Xia and Feng Yang Tian Lang. As a result, our contractual relationships with those companies could be viewed as entrenching his management position or transferring certain value to him, especially if any conflict with him arises.

If we are found to be in violation of current or future PRC laws, rules or regulations regarding Internet-related services and telecom-related activities, we could be subject to severe penalties.

The PRC has enacted regulations applying to Internet-related services and telecom-related activities. While many aspects of these regulations remain unclear, they purport to limit and require licensing of various aspects of the provision of Internet information, online advertising and value-added telecommunication services. In addition, the PRC may promulgate new laws, rules or regulations at any time. If these current or future laws, rules or regulations regarding Internet-related activities, are interpreted to be inconsistent with our ownership structure and/or our business operations, our business will be severely impaired and we could be subject to severe penalties. In addition, we may be required to apply for a new license or new qualification, or transfer from an old type of license to a new type of license at any time as a result of the requirements of newly promulgated laws or new regulations. From the promulgation of such requirement to the final issuance of the license or qualification, there might be a long pending period. Although the issuance of the new license will finally trace back to the date when filing such application, we may be held liable for operating without proper license and may be fined for the operation during the application period.

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We may not be able to collect payments of our wireless fees if the PRC government determines that our existing ownership structure does not comply with PRC laws, rules or regulations.

As discussed above, the PRC began several years ago to regulate its Internet sector by making pronouncements or enacting regulations regarding the legality of foreign investment in the PRC Internet sector. We believe that our current ownership structure complies with all existing PRC laws, rules and regulations. There are, however, substantial uncertainties regarding the interpretation of current PRC Internet laws and regulations. It is possible that the PRC government s view will ultimately be contrary to ours. If the PRC government were to take a contrary view, we might not be able to collect payments of our wireless fees, which we receive from Sohu Internet and Goodfeel, which in turn collect the fees from mobile network operators.

Even if we are in compliance with PRC governmental regulations relating to licensing and foreign investment prohibitions, the PRC government may prevent us from distributing, and we may be subject to liability for, content that it believes is inappropriate.

The PRC has enacted regulations governing Internet access and the distribution of news and other information. In the past, the PRC government has stopped the distribution of information over the Internet that it believes to violate PRC law, including content that is obscene, incites violence, endangers national security, is contrary to the national interest or is defamatory. In addition, we may not publish certain news items, such as news relating to national security, without permission from the PRC government. Furthermore, the Ministry of Public Security has the authority to cause any local Internet service provider to block any Website maintained outside the PRC at its sole discretion. Even if we comply with PRC governmental regulations relating to licensing and foreign investment prohibitions, if the PRC government were to take any action to limit or prohibit the distribution of information through our network or to limit or regulate any current or future content or services available to users on our network, our business would be harmed.

We are also subject to potential liabilities for content on our Websites that is deemed inappropriate and for any unlawful actions of our subscribers and other users of our systems under regulations promulgated by the MII, such potential liabilities including but not limited to imposition of fines, or, even shut-down of the Website.

Furthermore, we are required to delete content that clearly violates the laws of the PRC and report content that we suspect may violate PRC law. We may have difficulty determining the type of content that may result in liability for us and, if we are wrong, we may be prevented from operating our Websites.

We may not have exclusive rights over the marks that are crucial to our business, including but not limited to Sohu.com , Sogou , 17173 , Focus.cn , Goodfeel and Go2Map .

We have applied for the registration of our key marks in the PRC, including but not limited to Sohu.com, Sogou, 17173, Focus.cn, Goodfeel and Go2Map, so as to establish and protect our exclusive rights to the marks. We have succeeded in registering the marks Sohu.com , Focus.cn and Go2Map in the PRC under certain classes. The applications for the registration of the other marks or some marks under other classes are still under examination by the Trademark Office of PRC. Completion of the registrations is subject to the Trademark Office of PRC s determination that there are no prior rights in the PRC. Any rejection of these applications could adversely affect our rights to these marks.

Unauthorized use of our intellectual property by third parties, and the expenses incurred in protecting our intellectual property rights, may adversely affect our business.

We regard our copyrights, service marks, trademarks, trade secrets and other intellectual property as critical to our success. Unauthorized use of our intellectual property by third parties may adversely affect our business and reputation. We rely on trademark and copyright law, trade secret protection and confidentiality agreements with our employees, customers, business partners and others to protect our intellectual property rights. Despite our precautions, it may be possible for third parties to obtain and use our intellectual property without authorization. Furthermore, the validity, enforceability and scope of protection of intellectual property in Internet-related industries are uncertain and still evolving. In particular, the laws of the PRC and certain other

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countries are uncertain or do not protect intellectual property rights to the same extent as do the laws of the United States. Moreover, litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Future litigation could result in substantial costs and diversion of resources.

We may be subject to intellectual property infringement claims, which may force us to incur substantial legal expenses and, if determined adversely against us, materially disrupt our business.

We cannot be certain that our products, services and intellectual property used in our normal course of business do not or will not infringe valid patents, copyrights or other intellectual property rights held by third parties. We have in the past been, are currently, and may in the future be, subject to claims and legal proceedings relating to the intellectual property of others in the ordinary course of our business. In particular, if we are found to have violated the intellectual property rights of others, we may be enjoined from using such intellectual property, may be ordered to pay a fine and may incur licensing fees or be forced to develop alternatives. We may incur substantial expenses in defending against these third party infringement claims, regardless of their merit. Successful infringement claims against us may result in substantial monetary liability or may materially disrupt the conduct of our business by restricting or prohibiting our use of the intellectual property in question. In addition, we provide search engine facilities capable of locating and accessing links to download MP3 music, movies, images and other multimedia files and/or other content hosted on third party Websites, which may be protected by law. In a recent judgment in China, which has not come into effect yet, a court has found that one of the industry participants infringed the rights of copyright owners for its MP3 search services and ordered it to pay compensation. This judgment has increased our exposure to copyright infringement and therefore, we may face increasing amounts of claims or lawsuits relating to our MP3 services.

We may be subject to, and may expend significant resources in defending against claims based on the content and services we provide over all of our Websites.

As our services may be used to download and distribute information to others, there is a risk that claims may be made against us for defamation, negligence, copyright or trademark infringement or other claims based on the nature and content of such information. Furthermore, we could be subject to claims for the online activities of our visitors and incur significant costs in their defense. In the past, claims based on the nature and content of information that was posted online by visitors have been made in the United States against companies that provide online services. We do not carry any liability insurance against such risks.

We could be exposed to liability for the selection of listings that may be accessible through our Websites or through content and materials that our visitors may post in classifieds, message boards, chat rooms or other interactive services. If any information provided through our services contains errors, third parties may make claims against us for losses incurred in reliance on the information. We also offer Web-based e-mail and subscription services, which exposes us to potential liabilities or claims resulting from:

- unsolicited e-mail;
- lost or misdirected messages;
- illegal or fraudulent use of e-mail; or
- interruptions or delays in e-mail service.

Investigating and defending any such claims may be expensive, even if they do not result in liability.

Activities of Internet content providers are or will be subject to additional PRC regulations, which have not yet been put into effect. Our operations may not be consistent with these new regulations when put into effect, and, as a result, we could be subject to severe penalties.

The MII has stated that the activities of Internet content providers are subject to regulation by various PRC government authorities, depending on the specific activities conducted by the Internet content provider. Various government authorities have stated publicly that they are in the process of preparing new laws and regulations

that will govern these activities. The areas of regulation currently include online advertising, online news reporting, online publishing, online securities trading and the provision of industry-specific (e.g., drug-related) information over the Internet. Other aspects of our online operations may be subject to regulations in the future.

Our operations may not be consistent with these new regulations when put into effect and, as a result, we may be subject to severe penalties as discussed above.

Regulation and censorship of information distribution in China may adversely affect our business.

China has enacted regulations governing Internet access and the distribution of news and other information. Furthermore, the Propaganda Department of the Chinese Communist Party has been given the responsibility to censor news published in China to ensure, supervise and control a particular political ideology. In addition, the MII has published implementing regulations that subject online information providers to potential liability for contents included in their portals and the actions of subscribers and others using their systems, including liability for violation of PRC laws prohibiting the distribution of content deemed to be socially destabilizing. Because many PRC laws, regulations and legal requirements with regard to the Internet are relatively new and untested, their interpretation and enforcement may involve significant uncertainty. In addition, the PRC legal system is a civil law system in which decided legal cases have limited binding force as legal precedents. As a result, in many cases a Website operator may have difficulties determining the type of content that may subject it to liability.

Periodically, the Ministry of Public Security has stopped the distribution over the Internet of information which it believes to be socially destabilizing. The Ministry of Public Security has the authority to cause any local Internet service provider to block any Website maintained outside China at its sole discretion. If the PRC government were to take action to limit or eliminate the distribution of information through our portal or to limit or regulate current or future applications available to users of our portal, our business would be adversely affected.

The State Secrecy Bureau, which is directly responsible for the protection of state secrets of all PRC government and Chinese Communist Party organizations, is authorized to block any Website it deems to be leaking state secrets or failing to meet the relevant regulations relating to the protection of state secrets in the distribution of online information. Under the applicable regulations, we may be held liable for any content transmitted on our portal. Furthermore, where the transmitted content clearly violates the laws of the PRC, we will be required to delete it. Moreover, if we consider transmitted content suspicious, we are required to report such content. We must also undergo computer security inspections, and if we fail to implement the relevant safeguards against security breaches, we may be shut down. In addition, under recently adopted regulations, Internet companies which provide bulletin board systems, chat rooms or similar services, such as our company, must apply for the approval of the State Secrecy Bureau. As the implementing rules of these new regulations have not been issued, we do not know how or when we will be expected to comply, or how our business will be affected by the application of these regulations.

Political and economic policies of the PRC government could affect our business.

All of our business, operating assets, fixed assets and operations are located in China and all of our revenues are derived from our operations in China. Accordingly, our business may be adversely affected by changes in political, economic or social conditions in China, adjustments in PRC government policies or changes in laws and regulations.

The economy of China differs from the economies of most countries belonging to the Organization for Economic Cooperation and Development in a number of respects, including:

structure;

level of government involvement;

level of development;

level of capital reinvestment;

growth rate;

control of foreign exchange; and

methods of allocating resources.

Since 1949, China has been primarily a planned economy subject to a system of macroeconomic management. Although the Chinese government still owns a significant portion of the productive assets in China, economic reform policies since the late 1970s have emphasized decentralization, autonomous enterprises and the utilization of market mechanisms. We cannot predict what effects the economic reform and macroeconomic measures adopted by the Chinese government may have on our business or results of operations.

The PRC legal system embodies uncertainties which could limit the legal protections available to us and you, or could lead to penalties on us.

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the PRC government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. Our PRC operating subsidiaries, Beijing ITC and Sohu Era, are wholly-foreign owned enterprises, or WFOEs, which are enterprises incorporated in mainland China and wholly-owned by our indirect subsidiary, Sohu Hong Kong. Beijing ITC and Sohu Era are subject to laws and regulations applicable to foreign investment in mainland China. In addition, all of our subsidiaries and VIEs are incorporated in China and subject to all applicable Chinese laws and regulation. Because of the relatively short period for enacting such a comprehensive legal system, it is possible that the laws, regulations and legal requirements are relatively recent, and their interpretation and enforcement involve uncertainties. These uncertainties could limit the legal protections available to us and other foreign investors, including you, and may lead to penalties imposed on us because of the different understanding between the relevant authority and us. For example, according to current tax laws and regulation, we are responsible to pay business tax on a Self-examination and Self-application basis. However, since there is no clear guidance as to the applicability of those preferential treatments, we may be found in violation of the interpretation of local tax authorities with regard to the scope of taxable services and the percentage of tax rate and therefore might be subject to penalties, including but not limited to monetary penalties. In addition, we cannot predict the effect of future developments in the PRC legal system, particularly with regard to the Internet, including the promulgation of new laws, changes to existing laws or the interpretation or enforcement thereof, or the preemption of local regulations by national laws.

It may be difficult to enforce any civil judgments against us or our board of directors or officers, because most of our operating and/or fixed assets are located outside of the United States.

Although we are incorporated in the State of Delaware, most of our operating and fixed assets are located in the PRC. As a result, it may be difficult for investors to enforce judgments outside the United States obtained in actions brought against us in the United States, including actions predicated upon the civil liability provisions of the federal securities laws of the United States or of the securities laws of any state of the United States. In addition, certain of our directors and officers (principally based in the PRC) and all or a substantial portion of their assets are located outside the United States. As a result, it may not be possible for investors to effect service of process within the United States upon those directors and officers, or to enforce against them or us judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the federal securities laws of the United States or of the securities laws of any state of the United States. We have been advised by our PRC counsel that, in their opinion, there is doubt as to the enforceability in the PRC, in original actions or in actions for enforcement of judgments of United States courts, of civil liabilities predicated solely upon the federal securities laws of the United States or the securities laws of any state of the United States.

If tax benefits presently available to certain of our subsidiaries and VIEs located in China were not available, the income tax rate on most of our profits in China could increase to 33%.

Our China-based subsidiaries Sohu Era, Sogou Technology and our VIEs Sohu Internet and Sogou Information enjoy tax benefits which are available to new technology enterprises. Presently, PRC law requires that a company,

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in order to be considered a new technology enterprise : (i) operate in the high-tech industry (which includes the Internet industry); (ii) be incorporated and operating in High and New Technology Development Zones, including Beijing Zhongguancun Science Park; (iii) receive 60% of its revenue from high-tech products or services; and (iv) have at least 20% of its employees involved in technology development. Each year new technology enterprises are subject to annual inspection to determine whether they continue to meet these requirements.

Subject to the approval of the relevant tax authorities, the effective income tax rate for new technology enterprises registered and operating in Beijing Zhongguancun Science Park is 15%, while the local income tax will be exempted as long as the enterprise holds the new technology enterprise status. New technology enterprises are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction at the rate of 7.5% for the subsequent three years. Providing there is no change in the new technology enterprise status or change in relevant regulations, Sohu Era and Sohu Internet will be subject to an applicable tax rate of 7.5% in 2006 to 2008 and 15% thereafter, while Sogou Technology and Sogou Information will be subject to an applicable tax rate of 0% in 2006 to 2008, 7.5% in 2009 to 2011 and 15% thereafter.

For these tax benefits to no longer be available, there would need to be a change in governmental policy or the governmental regulations concerning requirements necessary to be deemed a new technology enterprise, or we would have to be unable to meet the existing new technology enterprise requirements. If we did not meet the requirements of a new technology enterprise, we may be subject to enterprise income tax in China at rates up to 33%, which could cause a significant reduction in our after-tax income.

Our subsidiaries and VIEs in China are subject to restrictions on paying dividends or making other payments to our overseas entities.

We are a holding company and do not have any assets or conduct any business operations in China other than our investments in our Chinese subsidiaries and VIEs. As a result, we depend on dividend payments from our subsidiaries in China after they receive payments from our VIEs under various services and other arrangements. It is possible that our Chinese subsidiaries will not continue to receive the payments in accordance with our contracts with our VIEs. To the extent that the VIEs have undistributed after tax net income, we must pay tax on behalf of our employees who hold interests in the VIEs when the VIEs distribute dividends in the future. The current dividend tax rate is 20%. In addition, under PRC law, our subsidiaries are only allowed to pay dividends to us out of their accumulated profits, if any, as determined in accordance with PRC accounting standards and regulations. Moreover, our Chinese subsidiaries are required to set aside at least 10% of their respective accumulated profits, if any, up to 50% of their registered capital to fund certain mandated reserve funds that are not payable or distributable as cash dividends.

The PRC government also imposes controls on the convertibility of RMB into foreign currencies and, in certain cases, the remittance of currencies out of China. We may experience difficulties in completing the administrative procedures necessary to obtain and remit foreign currencies. If we or any of our subsidiaries are unable to receive all of the revenues from our operations through these contractual or dividend arrangements, we may be unable to effectively finance our operations or pay dividends on our shares.

Restrictions on currency exchange may limit our ability to utilize our revenues effectively.

Substantially all of our revenues and operating expenses are denominated in RMB. The RMB is currently freely convertible under the current account , which includes dividends, trade and service related foreign exchange transactions, but not under the capital account , which includes foreign direct investment.

Currently, Beijing ITC or Sohu Era may purchase foreign exchange for settlement of current account transactions , including payment of dividends, without the approval of the State Administration for Foreign Exchange (or SAFE). Beijing ITC or Sohu Era may also retain foreign exchange in its current account (subject to

a ceiling approved by the SAFE) to satisfy foreign exchange liabilities or to pay dividends. However, the relevant PRC governmental authorities may limit or eliminate our ability to purchase and retain foreign currencies in the future.

Since a significant amount of our future revenues will be in the form of RMB, the existing and any future restrictions on currency exchange may limit our ability to utilize revenue generated in RMB to fund our business activities outside China, if any, or expenditures denominated in foreign currencies.

Foreign exchange transactions under the capital account are still subject to limitations and require approvals from the SAFE. This could affect Beijing ITC s or Sohu Era s ability to obtain foreign exchange through debt or equity financing, including by means of loans or capital contributions from us.

We may suffer currency exchange losses if the RMB depreciates relative to the US Dollar.

Our reporting currency is the US Dollar. However, substantially all of our revenues are denominated in RMB. In July 2005, China reformed its exchange rate regime by establishing a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. RMB is no longer be pegged to the US dollars and the exchange rate will have some flexibility. Hence, considering the floating exchange rate regime, if the RMB depreciates relative to the US Dollar, our revenues as expressed in our US Dollar financial statements will decline in value. In addition, there are very limited hedging transactions available in China to reduce our exposure to exchange rate fluctuations. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure, if at all. In addition, our currency exchange losses may be magnified by PRC exchange control regulations that restrict our ability to convert RMB into US Dollars.

The market price of our common stock has been and will likely continue to be volatile. The price of our common stock may fluctuate significantly, which may make it difficult for stockholders to sell shares of our common stock when desired or at attractive prices.

The market price of our common stock has been volatile and is likely to continue to be so. The initial public offering price of our common stock in July 2000 was $13.00 per share. The trading price of our common stock subsequently dropped to a low of $0.52 per share on April 9, 2001. During 2004, the trading price of our common stock ranged from a low of $13.56 per share to a high of $40.15 per share. During 2005, the trading price of our common stock ranged from a low of $14.66 per share to a high of $23.74 per share and during the six months ended June 30, 2006, the trading price of our common stock ranged from a low of $18.20 per share to a high of $29.43 per share. On July 31, 2006, the closing price of our common stock was $21.10 per share.

In addition, the Nasdaq Stock Market s National Market has from time to time experienced significant price and volume fluctuations that have affected the market prices for the securities of technology companies, and particularly Internet-related companies.

The price for our common stock may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements of technological innovations or new products and media properties by us or our competitors, changes in financial estimates and recommendations by securities analysts, the operating and stock price performance of other companies that investors may deem comparable to us, and news reports relating to trends in our markets or general economic conditions. Additionally, volatility or a lack of positive performance in our stock price may adversely affect our ability to retain key employees, all of whom have been granted stock options or other stock awards.

We issued $90.0 million of zero coupon convertible senior notes due July 2023 which we may not be able to repay in cash and could result in dilution of our earnings per share.

In July 2003, we issued $90 million aggregate principal amount of zero coupon convertible senior notes due July 2023. The notes are convertible into our common stock at a conversion price of $44.76 per share, subject to

adjustment upon the occurrence of specified events, which would result in the issuance of an aggregate of approximately two million shares. Therefore, each $1,000 principal amount of the notes will initially be convertible into 22.3414 shares of our common stock. Each holder of the notes will have the right, at the holder s option, to require Sohu to repurchase all or any portion of the principal amount of the holder s notes on July 14 in 2007, 2013 and 2018 at a price equal to 100% of the outstanding principal amount. We had early redeemed our zero coupon convertible senior notes with face value of $30,220,000 from the market in 2005 and 2006. As of June 30, 2006, the face value of remaining outstanding zero coupon convertible senior notes was $59.8 million. We may also be required to repurchase all of the outstanding notes following a fundamental change of Sohu, such as a change of control, prior to maturity. We may not have enough cash on hand or the ability to access cash to pay the notes if presented for redemption on a fundamental change, on a redemption date referred to above or at maturity. In addition, the redemption or purchase of our notes with shares of our common stock or the conversion of the notes into our common stock could result in a reduction of our earnings per share.

We are controlled by a small group of our existing stockholders, whose interests may differ from other stockholders.

Our chief executive officer, Dr. Zhang, beneficially owns approximately 26.3% of the outstanding shares of our common stock and is our largest stockholder. Our chief executive officer, together with our other executive officers and members of our Board of Directors, beneficially own approximately 29.5% of the outstanding shares of our common stock. Accordingly these stockholders acting together will have significant influence in determining the outcome of any corporate transaction or other matter submitted to the stockholders for approval, including mergers, consolidations, the sale of all or substantially all of our assets, election of directors and other significant corporate actions. They will also have significant influence in preventing or causing a change in control. In addition, without the consent of these stockholders, we may be prevented from entering into transactions that could be beneficial to us. The interests of these stockholders may differ from the interests of the other stockholders.

Anti-takeover provisions of the Delaware General Corporation Law, our certificate of incorporation and Sohu s Stockholder Rights Plan could delay or deter a change in control.

Some provisions of our certificate of incorporation and by-laws, as well as various provisions of the Delaware General Corporation Law, may make it more difficult to acquire our company or effect a change in control of our company, even if an acquisition or change in control would be in the interest of our stockholders or if an acquisition or change in control would provide our stockholders with a premium for their shares over then current market prices. For example, our certificate of incorporation provides for the division of the board of directors into two classes with staggered two-year terms and provides that stockholders have no right to take action by written consent and may not call special meetings of stockholders, each of which may make it more difficult for a third party to gain control of our board in connection with, or obtain any necessary stockholder approval for, a proposed acquisition or change in control.

In addition, we have adopted a stockholder rights plan under the terms of which, in general, if a person or group acquires more than 20% of the outstanding shares of common stock, all other Sohu stockholders would have the right to purchase securities from Sohu at a substantial discount to those securities fair market value, thus causing substantial dilution to the holdings of the person or group which acquires more than 20%. The stockholder rights plan may inhibit a change in control and, therefore, could adversely affect the stockholders ability to realize a premium over the then-prevailing market price for the common stock in connection with such a transaction.

The power of our Board of Directors to designate and issue shares of preferred stock could have an adverse effect on holders of our common stock.

Our certificate of incorporation authorizes our board of directors to designate and issue one or more series of preferred stock, having rights and preferences as the board may determine, and any such designations and issuances could have an adverse effect on the rights of holders of common stock.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS

FOREIGN CURRENCY EXCHANGE RATE RISK

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

The RMB is currently freely convertible under the current account , which includes dividends, trade and service-related foreign exchange transactions, but not under the capital account , which includes foreign direct investment. In addition, commencing on July 21, 2005, China reformed its exchange rate regime by changing to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Under the managed floating exchange rate regime, the RMB is no longer pegged to the US Dollar. The exchange rate of the RMB against the US Dollar was adjusted to RMB 8.11 per US Dollar as of July 21, 2005, representing an appreciation of about 2%. The People s Bank of China will announce the closing prices of foreign currencies such as the US Dollar traded against the RMB in the inter-bank foreign exchange market after the closing of the market on each business day, and will make such prices the central parity for trading against the RMB on the following business day. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure. Accordingly, we may incur economic losses in the future due to foreign exchange rate fluctuations, which could have a negative impact on our financial condition and results of operations.

The following table provides information, by maturity date, regarding our foreign currency sensitive financial instruments, which consist of cash and cash equivalents, restricted cash, receivables, investments in marketable debt securities, payables and zero coupon convertible senior notes as of June 30, 2006:

	Expected Maturity Date Before June 30,						Total recorded	Fair
	2007	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**value**	**value**
On-balance sheet financial instruments (in US$ 000)								
Cash and cash equivalents								
in US$	32,418						32,418	32,418
in RMB	86,325						86,325	86,325
in HK$	275						275	275
Sub-total	119,018						119,018	119,018
Restricted cash								
in RMB			1,001				1,001	1,001
Receivables								
in US$	440	90					530	530
in RMB	27,207	783					27,990	27,990
in HK$	18	624					642	642
Sub-total	27,665	1,497					29,162	29,162
Investments in marketable debt securities								
in US$	9,004	4,876					13,880	13,880
Payables								
in US$	5,126						5,126	5,126

in RMB	29,758		29,758	29,758
in HK$	38		38	38
Sub-total	34,922		34,922	34,922
Zero coupon convertible senior notes				
In US$		59,780	59,780	56,041

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INVESTMENT RISK

Sohu invests in marketable debt securities to preserve principal while at the same time maximizing yields without significantly increasing risk. These marketable debt securities are classified as available-for-sale because we may dispose of the securities prior to maturity and they are thus reported at the market value as of the end of the period. As of June 30, 2006, an unrealized loss of $225,000 was recorded as accumulated other comprehensive income in shareholders equity.

INTEREST RATE RISK

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

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

The following table provides information, by maturity date, regarding our interest rate sensitive financial instruments, which consist of marketable debt securities and zero coupon convertible senior notes as of June 30, 2006.

	Expected Maturity Date Before June 30,							
(US$ 000)	2007	2008	2009	2010	2011	Thereafter	Total recorded value	Fair value
Investments in marketable securities	9,004	4,876					13,880	13,880
Average interest rate	5.97%	4.40%						
Zero coupon convertible senior notes		59,780					59,780	56,041
Average interest rate		0%						

ITEM 4. CONTROLS AND PROCEDURES

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

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

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

There are no material legal proceedings pending or, to our knowledge, threatened against us. From time to time we become subject to legal proceedings and claims in the ordinary course of our business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights, and a variety of claims arising in connection with our email, message boards, auction sites, shopping services, and other communications and community features, such as claims alleging defamation or invasion of privacy. However, such legal proceedings or claims, even if not meritorious, could result in the expenditure of significant financial and management resources.

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

Use of Proceeds

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

During the six months ended June 30, 2006, we did not use any proceeds from the offering. The remaining net proceeds from the offering have been invested in cash, cash equivalents, and marketable debt securities. The use of the proceeds from the offering does not represent a material change in the use of proceeds described in the prospectus contained in the Registration Statement on Form S-1 described above.

In October 2005, the board of directors approved our repurchase of outstanding shares of our common stock from the open market, on an opportunistic basis, up to $15 million. As of August 1, 2006, we had repurchased a total of 690,581 shares, fully utilizing the $15 million available under this initial program. On July 25, 2006, the board of directors approved an additional $15 million stock repurchase program.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On June 9, 2006, Sohu held its Annual Meeting of Stockholders. At the meeting, the stockholders elected as directors Ms. Mary Ma (with 25,826,563 affirmative votes and 4,090,966 votes withheld) and Dr. Edward B. Roberts (with 29,534,739 affirmative votes and 382,790 votes withheld).

The stockholders also approved an amendment to Sohu s 2000 Stock Incentive Plan to include restricted stock units among the types of incentives that may be granted to Sohu s directors, officers, employees, consultants and advisors under the plan (with 11,443,840 shares voting for, 7,394,626 against, 16,238 abstaining and 11,062,825 broker non-votes).

The stockholders also ratified the appointment of PricewaterhouseCoopers Zhong Tian CPAs Limited Company as Sohu s independent accountants for the fiscal year ending December 31, 2006 (with 29,845,749 shares voting for, 65,306 against, and 6,474 abstaining).

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Please see the Exhibit Index attached hereto.

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SIGNATURES

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

Dated: August 8, 2006

SOHU.COM INC.

By: /s/ CAROL YU
Chief Financial Officer

(Principal Financial Officer)

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Sohu.com Inc.

Quarterly Report on Form 10-Q For Quarter Ended June 30, 2006

EXHIBITS INDEX

31.1 Rule 13a-14(a)/15d-14(a) Certification of Charles Zhang

31.2 Rule 13a-14(a)/15d-14(a) Certification of Carol Yu

32.1 Section 1350 Certification of Charles Zhang

32.2 Section 1350 Certification of Carol Yu