

INFOSPACE INC
Form 10-K
February 23, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from _____ to _____

Commission File Number 0-25131

INFOSPACE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

91-1718107
(IRS Employer

Edgar Filing: INFOSPACE INC - Form 10-K

incorporation or organization)

Identification No.)

601 108th Avenue NE, Suite 1200, Bellevue, Washington 98004

(Address of principal executive offices) (Zip code)

Registrant's telephone number, including area code:

(425) 201-6100

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$.0001 per share

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark whether the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Edgar Filing: INFOSPACE INC - Form 10-K

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The aggregate market value of the voting stock held by non-affiliates of the registrant outstanding as of June 30, 2005, based upon the closing price of Common Stock on June 30, 2005 as reported by Nasdaq, was \$1,063.8 million. Shares of voting stock held by each officer and director and by each person who owns 5% or more of the outstanding voting stock (as publicly reported by such persons pursuant to Section 13 and Section 16 of the Securities Exchange Act of 1934) have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 17, 2006, 31,081,054 shares of the registrant's Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from the definitive proxy statement for the Annual Meeting of Stockholders tentatively scheduled for May 8, 2006 (the "Proxy Statement").

Table of Contents

TABLE OF CONTENTS

Part I

Item 1.	<u>Business</u>	3
Item 1A.	<u>Risk Factors</u>	11
Item 1B.	<u>Unresolved Staff Comments</u>	22
Item 2.	<u>Properties</u>	23
Item 3.	<u>Legal Proceedings</u>	23
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	23

Part II

Item 5.	<u>Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	24
Item 6.	<u>Selected Consolidated Financial Data</u>	25
Item 7.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
Item 7A.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	47
Item 8.	<u>Financial Statements and Supplementary Data</u>	48
Item 9.	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	82
Item 9A.	<u>Controls and Procedures</u>	82
Item 9B.	<u>Other Information</u>	84

Part III

Item 10.	<u>Directors and Executive Officers of the Registrant</u>	84
Item 11.	<u>Executive Compensation</u>	84
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	84
Item 13.	<u>Certain Relationships and Related Transactions</u>	84
Item 14.	<u>Principal Accounting Fees and Services</u>	84

Part IV

Item 15.	<u>Exhibits, Financial Statement Schedules</u>	85
	<u>Signatures</u>	88

Table of Contents

ITEM 1. Business

This report contains forward-looking statements that involve risks and uncertainties. The statements contained in this report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use words such as anticipate, believe, plan, expect, future, intend, may, will, should, predict, potential, continue, and similar expressions to identify such forward-looking statements. Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that may cause our results, levels of activity, performance, achievements and prospects, and those of the wireless and Internet software and application services industry generally, to be materially different from those expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include, among others, those identified under Item 1A. Risk Factors Factors Affecting Our Operating Results, Business Prospects and Market Price of Stock and elsewhere in this report.

On September 13, 2002, we effected a one-for-ten reverse split of our issued and outstanding common stock. Historical share numbers and prices throughout this Annual Report on Form 10-K are split-adjusted.

Overview

InfoSpace, Inc. (InfoSpace , Our or We) is a provider and publisher of mobile content, products and services that enhance the wireless experience, assisting consumers with finding information, personalization and entertainment on the mobile phone. We also use our technology, including metasearch, to power our own branded Web sites and provide private-label online search and directory services to distribution partners. We were founded in 1996 and are incorporated in the state of Delaware. Our principal corporate offices are located in Bellevue, Washington. We also have facilities in Los Angeles and San Mateo, California; Westborough, Massachusetts; Woking and Eastleigh, United Kingdom; Papendrecht, The Netherlands; and Hamburg, Germany. Our common stock is listed on the Nasdaq Stock Market under the symbol INSP.

We focus on two businesses: Mobile and Search & Directory, and have expanded both businesses, including the acquisition of an online directory company and mobile content and application businesses. We plan to leverage our intellectual capital and core competencies to focus more on mobile applications, products, and services. As part of this plan, in early 2006 we realigned our operations to a functional organization structure, eliminating the separate business units of Mobile and Search & Directory, and plan to expand our mobile media offerings, leverage our online search and directory technology and applications for mobile devices, and expand our distribution channels.

Company Internet Site and Availability of SEC Filings. Our corporate Internet site is located at www.infospaceinc.com. We make available on that site our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K, as well as any amendments to those filings, and other filings we make electronically with the U.S. Securities and Exchange Commission (the SEC). The filings can be found in the Investor Relations section of our site and are available free of charge. Information on our Internet site is not part of this Form 10-K. The SEC maintains an Internet site at www.sec.gov that contains reports, proxy and information statements, and other information regarding us and other issuers that file electronically with the SEC.

MOBILE

Edgar Filing: INFOSPACE INC - Form 10-K

Our Mobile business provides media products and content to mobile operators and portal and infrastructure services that enable mobile operators to deliver content and programming across multiple devices to their subscribers. Through our products, content and service offerings, our mobile operator partners are able to aggregate, configure and customize the services they offer under their own brand and deliver them to their subscribers.

Our Mobile business generates revenue primarily from transaction fees and, to a lesser extent, subscriber fees, revenue sharing fees, set-up fees and professional service fees. As of December 31, 2005, we had relationships with many leading mobile operators, including Cingular Wireless, T-Mobile, Verizon Wireless and Virgin Mobile US, and record labels including UMG Recordings, Sony BMG and Warner Music Group.

Table of Contents

Competitors include mobile application providers, mobile application aggregators, mobile application enablers, entertainment and other digital media companies, and the mobile operators themselves.

SEARCH & DIRECTORY

Our search and directory services enable Internet users to locate information, merchants, individuals and products online. We offer search and directory services through our branded Web sites, Dogpile.com, Switchboard.com, InfoSpace.com, Webcrawler.com and MetaCrawler.com, as well as through the Web properties of distribution partners. Partner versions of our search and directory services are generally private-labeled and delivered with each distribution partner's unique requirements.

Our Search properties enable Internet users to locate relevant information, merchants and products online. We deliver results from leading search engines, including Yahoo! and Google, among others. Our search offerings differ from most other mainstream search services in that they provide metasearch technology that selects results from several search engines. We offer search services through our own Web sites, as well as through the Web properties of distribution partners including WhenU.com, WebSearch.com, Cablevision, Verizon Online, ZapMeta.com and others. The majority of search revenue growth since 2004 was generated through the growth of existing distribution partners and the addition of new distribution partners.

Our directory services include online yellow and white pages services. InfoSpace directory properties help Internet users find local and national merchants and individuals in North America. We offer directory services through our branded Web sites, such as Switchboard.com and InfoSpace.com, as well as through distribution partner relationships. We obtain the underlying directory listings primarily through our relationships with Verizon and Yellowpages.com.

We compete against other providers of Web search services, major Internet portals and Web-based directories. We also compete against more traditional advertising media, including radio, network and cable television, newspaper, magazines, Internet, direct mail and others for a share of the U.S. advertising media market.

Seasonality

Our online search and directory services are affected by seasonal fluctuations in Internet usage, which generally declines in the summer months. Our mobile products and services may also be subject to seasonality based on the timing of consumer product cycles and other factors, such as the timing of new mobile phone sales.

International Operations

We currently maintain facilities in the United States, the United Kingdom, Germany and The Netherlands.

Edgar Filing: INFOSPACE INC - Form 10-K

We have historically generated most of our revenues from customers in the United States. Revenue generated in the United States accounted for 93% in 2005, 93% in 2004 and 88% in 2003 of our total revenues in those years.

Revenue Sources

Our revenues are derived from products and services delivered to our customers and distribution partners across our two businesses, Mobile and Search & Directory. We derive a significant portion of our revenue from a small number of customers and we expect that this concentration will continue in the foreseeable future. Cingular Wireless, Yahoo! and Google each accounted for more than 10% of our revenues in 2005.

Mobile Revenue: We earn revenues, typically through agreements with mobile operators, for the delivery of mobile media download products, such as ringtones, graphics and games, as well as services, which include

Table of Contents

subscriber usage, hosting and maintenance services, and professional services. We recognize revenue from a media download product when it is delivered. We recognize subscriber usage revenues based on a fee per user or per usage by the end user. We recognize revenue from hosting services and maintenance of such services in the period in which the service is provided. We sometimes earn one-time user set-up fees, which are generally amortized over the term of the customer contract. We also generate revenues from professional services, which are recognized as revenue in the period in which the work is completed and accepted by the customer.

Search & Directory Revenue: We generate revenues from our Web search and directory services when an end user of our services generates a paid search at our Web site. We also generate revenues from paid searches through a distribution partner's Web property. Revenues are recognized in the period in which a paid search occurs and are based on the amounts earned and remitted to us by our customer content providers. We also generate advertising revenues by selling banner, button and text-link advertisements based on cost per search or page view, which are recognized when the services are delivered.

Product Development

We believe that our technology is essential to successfully implement our strategy of expanding and enhancing our products and services, expanding in the mobile media market and maintaining the attractiveness and competitiveness of our products and services. Product development expenses were \$31.2 million in the year ended December 31, 2005, \$23.1 million in the year ended December 31, 2004, and \$17.8 million in the year ended December 31, 2003.

Intellectual Property

Our success depends significantly upon our technology. To protect our rights, we rely on a combination of copyright and trademark laws, patents, trade secrets, confidentiality agreements with employees and third parties and protective contractual provisions. Most of our employees have executed confidentiality and non-use agreements that contain provisions prohibiting the unauthorized disclosure and use of our confidential and proprietary information and that transfer to us any rights they may have in copyrightable works or patentable technologies that they may develop while under our employ. In addition, prior to entering into discussions with third parties regarding our business and technologies, we generally require that such parties enter into nondisclosure agreements with us. If these discussions result in a license or other business relationship, we also generally require that the agreement setting forth the parties' respective rights and obligations include provisions for the protection of our intellectual property rights. For example, the standard language in our agreements with distribution partners provides that we retain ownership of all patents and copyrights in our technologies and requires them to display our patent, copyright and trademark notices.

We hold over 50 U.S. registered trademarks and over 100 foreign trademarks registered in various countries. We also have applied for registration of certain service marks and trademarks in the United States and in other countries, and will seek to register additional marks in the U.S. and foreign countries, as appropriate. We may not be successful in obtaining registration for the service marks and trademarks for which we have applied.

We hold over 30 U.S. and foreign patents. Our issued patents relate to our online directory, advertisement and location services, among others. We are currently pursuing certain pending U.S. and foreign patent applications that relate to various aspects of our technology. We anticipate on-going patent application activity in the future. However, patent claims may not be issued and, if issued, may be challenged or invalidated by third parties. In addition, issued patents may not provide us with any competitive advantages.

Edgar Filing: INFOSPACE INC - Form 10-K

Despite our efforts to protect our rights, unauthorized parties may copy aspects of our products or services or obtain and use information that we regard as proprietary. The laws of some foreign countries do not protect proprietary rights to as great an extent as do the laws of the United States. In addition, others could independently develop substantially equivalent intellectual property. If we do not effectively protect our intellectual property, our business could suffer.

Table of Contents

Companies and individuals in the arts and entertainment industry, as well as in the Internet software and application services industry, have frequently resorted to litigation regarding intellectual property rights. We may have to litigate to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of others' proprietary rights which are sometimes not clear or may change. From time to time, we have received, and may receive in the future, notice of claims of infringement of others' proprietary rights. Responding to any such claims could be time-consuming, result in costly litigation, divert management's attention, cause product or service release delays, require us to redesign our products or services or require us to enter into royalty or licensing agreements. If a successful claim of infringement were made against us and we could not develop non-infringing technology or license the infringed or similar technology on a timely and cost-effective basis, our business could suffer.

MetaCrawler License Agreement. We hold an exclusive, perpetual worldwide license, subject to certain limited exceptions, to the MetaCrawler intellectual property and related search technology from the University of Washington, which we use in our Search business.

Competition

We operate in the mobile entertainment, personalization and services markets and online search and directory markets, which are extremely competitive and rapidly changing. Our current and prospective competitors include many large companies that have substantially greater resources than we have. We believe that the primary competitive factors in the market for mobile entertainment, personalization and services and Internet applications are:

our customers going direct to our distribution partners or our third party content providers;

the ability to meet the specific information and service demands of a particular Web property, mobile device or platform;

the cost-effectiveness, reliability and security of the products and application services;

the ability to provide products and application services that are innovative and attractive to consumers, subscribers and other end users;

the ability to develop innovative products and services that enhance the appearance and utility of the Web property, mobile device or platform; and

the ability to meet the needs of mobile operators and other major customers.

Although we believe that no one competitor offers all of the products and services we do, our primary offerings face competition from various sources. We compete, directly or indirectly, in the following ways, among others:

Our distribution partners and third party content providers are also our competitors.

Edgar Filing: INFOSPACE INC - Form 10-K

Our mobile services compete with mobile application aggregators, mobile application enablers, media companies, content developers and publishers, and in-house information technology departments of mobile operators and device manufacturers.

Our search services compete with search providers and Internet portals such as Google, Yahoo! and Microsoft's MSN. Our online directory services compete with Internet portals and print and Web-based directories. These services also compete against more traditional advertising media, including radio, network and cable television, newspaper, magazines, Internet, direct mail and others for a share of the U.S. advertising market. Other information services we provide compete with specialized content providers.

In international markets, we compete with local companies which may have a competitive advantage due to their greater understanding of and focus on a particular local market.

We expect that in the future we will experience competition from other Internet application and mobile services companies, as well as from content providers. Some of these companies are currently customers, distribution partners or content providers of ours, the loss of which could harm our business.

Table of Contents

Many of our current customers have established relationships with some of our current and potential future competitors. Some of our customers are also our competitors. If our competitors develop software and application services that are superior to ours, or that achieve greater market acceptance than ours, our business will suffer.

Governmental Regulation

Because of the increasing use of the Internet and wireless devices, U.S. and foreign governments have adopted or may in the future adopt laws and regulations relating to the Internet or use of wireless devices, addressing issues such as user privacy, security, pricing, age verification, content, taxation, copyrights, distribution, advertising and product and services quality.

Recent concerns regarding Internet and wireless device user privacy have led to the introduction of U.S. federal and state legislation to protect user privacy. Existing laws regarding user privacy that we may be subject to include the Children's Online Privacy Protection Act, which regulates the online and, in some interpretations, wireless collection of personal information from children under 13, and the Gramm-Leach-Bliley Act, which regulates the collection and processing of personal financial information. Also, with respect to our tournament games, certain states regulate the provision of prizes for mobile games or other contests, and other states may adopt similar regulations. In addition, the Federal Trade Commission (the "FTC") has initiated investigations and hearings regarding Internet user privacy and data security, which could result in rules or regulations that could adversely affect our business. Various states have likewise sought to regulate advertising, privacy and data security in ways that may affect the collection, use and disclosure of information. For example, California has passed several laws relating to the collection, storage and distribution of personal information, requiring in part the posting of a privacy policy and disclosure of how information is shared with third parties for marketing purposes. We could become subject to new laws and regulations that could limit our ability to conduct targeted advertising, to distribute or collect user information or impose new data security costs on us.

Countries outside of the United States may have more restrictive privacy laws. The European Union, for example, strictly regulates the collection, use and transfer of personal information of European residents. Further, information lawfully collected in the European Union may not be transferred for processing outside Europe to a country that lacks adequate protections. The European Union has deemed the U.S. to lack such protections and transfers of personal information gathered in Europe to the United States are only permitted under limited circumstances. Other countries such as Canada follow the European model. These and similar restrictions may limit our ability to collect and use information regarding Internet users in those countries.

We may be subject to provisions of the Federal Trade Commission Act and similar state laws that regulate advertising in all media, including the Internet, and require advertisers to substantiate advertising claims before disseminating advertising. The FTC and various state attorneys general have recently brought actions charging deceptive advertising via the Internet and may actively monitor Internet advertising. The United States and various individual states have also enacted restrictions on advertising through other media. For example, in the United States, the Telephone Consumer Protection Act and the recently enacted "Do Not Call" legislation regulate the manner in which we may advertise goods and services via telephones and facsimiles.

Other countries similarly regulate direct and indirect marketing. For example, the European Union has enacted an electronic communications directive that imposes certain restrictions on the use of cookies and action tags as well as the sending of unsolicited communications.

We may also be subject to the provisions of the Child Online Protection Act, which restricts the distribution of certain materials deemed harmful to children. The Act is also designed to restrict access to such materials by children, and accordingly, the provisions of this Act may apply to certain Internet and wireless product and service providers even though such companies are not engaged in the business of distributing the

Edgar Filing: INFOSPACE INC - Form 10-K

harmful materials. Although some court decisions have cast doubt on the constitutionality of the Act, and we have instituted processes for voluntary compliance with provisions of the Act that may be relevant to our business, the Act could subject us to liability.

Table of Contents

These or other laws or regulations that may be enacted in the future could have adverse effects on our business, including higher regulatory compliance costs, limitations on our ability to provide some services in some countries, and liabilities which might be incurred through lawsuits or regulatory penalties. For example, numerous states now require that companies notify individuals of security breaches that may result in third parties gaining unauthorized access to certain types of personal information. We believe we take reasonable steps to protect the security and confidentiality of the information we collect and store but there is no guarantee that third parties will not gain unauthorized access despite our efforts or that we will not incur costs in complying with our notification obligations under such circumstances.

Employees

As of February 17, 2006, we had approximately 620 employees. None of our employees are represented by a labor union and we consider employee relations to be positive. There is significant competition for qualified personnel in our industry, particularly for software development and other technical staff. We believe that our future success will depend in part on our continued ability to hire and retain qualified personnel.

Executive Officers and Directors of the Registrant

The following table sets forth certain information as of February 17, 2006 with respect to our executive officers and directors:

Name	Age	Position
James F. Voelker	54	Chairman, Chief Executive Officer and President
David E. Rostov	40	Chief Financial Officer
Edmund O. Belsheim, Jr.	53	Chief Administrative Officer and Director
Stephen J. Davis	44	President, Mobile and Online Media
Steven L. Elfman	50	Executive Vice President, Technology and Operations and Managing Director of Europe
Brian T. McManus	48	Executive Vice President, Sales and Business Development
Allen M. Hsieh	45	Chief Accounting Officer and VP Financial Operations
John E. Cunningham, IV	48	Director
Jules Haimovitz	55	Director
Richard D. Hearney	66	Director
Rufus W. Lumry, III	59	Director
Lewis M. Taffer.	58	Director
George M. Tronsrue, III	49	Director
Vanessa A. Wittman	38	Director

James F. Voelker has served as our Chairman and Chief Executive Officer since December 2002, and also as President since December 2005. He also held the title of President from December 2002 to April 2003. He has served as a director since July 2002. Mr. Voelker served as President and a director of NEXTLINK Communications, Inc. (now XO Communications, Inc.), a broadband communications company, from inception in 1994 through 1998. Prior to NEXTLINK, he served as Chief Executive Officer and a director of U.S. Signal, a full service competitive local exchange carrier.

David E. Rostov was appointed Chief Financial Officer in April 2003. From March 2001 to November 2002, he served as Chief Financial Officer of Apex Learning Inc., a provider of online advanced placement courses for U.S. high schools. From May 2002 to November 2002, he also served as acting Chief Operating Officer of Apex Learning. Prior to Apex Learning, he served as Chief Financial Officer of drugstore.com,

Edgar Filing: INFOSPACE INC - Form 10-K

Inc., an online drugstore, from January 1999 to January 2001. We recently announced that Mr. Rostov plans to resign during the first half of 2006 to pursue other opportunities.

Edmund O. Belsheim, Jr. has been a director since January 2001. Mr. Belsheim joined us in November 2000 as Senior Vice President and General Counsel, and was appointed Chief Operating Officer in January 2001 and

Table of Contents

Chief Administrative Officer in April 2003. He also served as President from July 2001 to December 2002. From April 1999 to November 2000, Mr. Belsheim was a partner at Perkins Coie LLP, a Seattle-based law firm. From 1996 to 1998, Mr. Belsheim served as Vice President, Corporate Development, General Counsel and Secretary of Penford Corporation, a maker of specialty starches. He also served as Senior Vice President, Corporate Development, General Counsel and Secretary of Penwest Pharmaceuticals Co., an oral drug delivery technology and products company. Prior to joining Penford Corporation, Mr. Belsheim was a member of the law firm Bogle & Gates, P.L.L.C.

Stephen J. Davis joined us in November 2005 as President, Mobile Media and was appointed President, Mobile and Online Media in January 2006. Prior to joining us, Mr. Davis was a production consultant from June 2005 to November 2005. From February 2004 to June 2005, Mr. Davis served as President of Granada America (the dba of Granada International Media, Inc.), the U.S.-based production and development division of ITV plc, one of Europe's largest media companies. From September 1999 to January 2004, Mr. Davis was President and Chief Executive Officer of Carlton America (the dba of Carlton International Media Inc.), which became known as Granada America after it was acquired by Granada in 2004, and also served as a director of Carlton International Media Limited, a global distribution company of television programs and feature films. From January 1997 to September 1999, Mr. Davis served as President and Chief Executive Officer of Hamdon Entertainment, at that time one of the world's largest distributors of made-for-television movies. Mr. Davis serves as co-chairman of the National Association of Television Program Content Executives, a non-profit association of television program executives. He is also a member of the British Academy of Film and Television Arts, the Academy of Television Arts and Sciences and the Hollywood Radio and Television Society.

Steven L. Elfman was appointed Executive Vice President, Technology and Operations and Managing Director of Europe in August 2005, after serving as Vice President-Mobile Operations from November 2004 to July 2005, and as Chief Technology Officer and Vice President-Engineering and Operations from July 2003 to November 2004. From May 2003 to July 2003, he was a consultant to Accenture Ltd., a consulting company. From September 2001 to May 2003, Mr. Elfman served as Executive Vice President of Operations at Terabeam Corp., a provider of fiberless optics communications. He also served as Terabeam's Executive Vice President Network Operations and Chief Information Officer from December 2000 to September 2001, and as Senior Vice President Customer and Corporate Services and Chief Information Officer from April 2000 to December 2000. From July 1997 to April 2000, Mr. Elfman was Senior Vice President and Chief Information Officer at AT&T Wireless Services, Inc.

Brian T. McManus joined us in April 2003 as Executive Vice President, Search and Directory and was appointed Executive Vice President Sales and Business Development in January 2006. From April 2000 to October 2002, he served as Vice President of Corporate Development at Internet service provider Epoch Internet. From October 1999 to April 2000, he served as Chief Operating Officer of Bazillion Inc., an Internet service provider. From December 1993 to October 1999, he served in a variety of executive positions in Seattle area technology companies, including Chief Executive Officer of Intermind Corporation, an open-source software company, and Chief Executive Officer of AccessLine Technologies Inc., a telecommunications company.

Allen M. Hsieh joined us in June 2003 as Chief Accounting Officer and Vice President Financial Operations. From February 2000 to March 2003, he served as Vice President Finance at Terabeam Corp., a provider of fiberless optics communications. Prior to Terabeam he served in various positions at PricewaterhouseCoopers LLP, a big four accounting firm, from July 1985 to February 2000, and the last two years as a partner in their accounting and auditing practice.

John E. Cunningham, IV has served as a director of InfoSpace since July 1998. Mr. Cunningham has been a general partner of Clear Fir Partners, L.P., a private equity investment partnership, since February 1998. Since January 2004, he has served as a non-executive chairman of the board of Citel Technologies, Inc., a telecommunications company. From April 1995 until February 2003, he served as President of Kellett Investment Corporation, an investment fund for private companies. Mr. Cunningham is on the Board of Directors of Petra Capital, LLC and Revenue Science, Inc. (formerly digiMine.com), and also serves as an advisor to Petra Growth Fund, L.P.

Table of Contents

Jules Haimovitz was appointed as a director in October 2005. Since July 2002, Mr. Haimovitz has served as Vice Chairman and Managing Partner of Dick Clark Productions Inc., a producer of programming for television, cable networks and syndicators. From June 1999 to July 2004, Mr. Haimovitz served in various capacities at Metro Goldwyn Mayer Inc, including President of MGM Networks Inc., a wholly-owned subsidiary, Executive Consultant to the CEO, and Chair of the Library Task Force. From July 1997 to February 1999, he served as President and Chief Operating Officer of King World Productions, Inc., a leading worldwide distributor of first-run programming. Mr. Haimovitz has also served in executive positions at Diva Systems Corporation, a leading supplier of Video on Demand (VOD) technology, ITC Entertainment Group, Spelling Entertainment Inc. and Viacom Inc. Mr. Haimovitz is on the Board of Directors of TVN Entertainment Corporation and GNet Productions.

Richard D. Hearney has served as a director since September 2001. General Hearney served as President and Chief Executive Officer of Business Executives for National Security, an organization focusing on national security policy, from December 2000 to April 2002. He joined McDonnell Douglas Corporation in 1996 and served as Regional Vice President of Business Development Western Europe until the acquisition of McDonnell Douglas by The Boeing Company in 1997, and subsequently served as Vice President of the Military Aircraft and Missile Systems Group of Boeing until November 1999. General Hearney served in the United States Marine Corps for over 35 years, and retired from military service in 1996 as Assistant Commandant of the Marine Corps. General Hearney currently serves on the Board of Directors of AOptix Technologies, Inc.

Rufus W. Lumry, III has served as a director of InfoSpace since December 1998. Since September 1992, Mr. Lumry has served as President of Acorn Ventures, Inc., a venture capital firm he founded. Prior to founding Acorn Ventures, Mr. Lumry served as a director and Chief Financial Officer of McCaw Cellular Communications. Mr. Lumry was one of the founders of McCaw Cellular in 1982, and retired from McCaw Cellular in 1990 as Executive Vice President and Chief Financial Officer.

Lewis M. Taffer has served as a director since June 2001. Mr. Taffer is currently an independent management consultant. From January 2004 to January 2005, Mr. Taffer served as Executive Vice President, Acquisition Marketing of America Online. From May 2001 through December 2003, Mr. Taffer was an independent consultant specializing in marketing, business development and strategic partnerships. From 1979 through May 2001, Mr. Taffer served in various positions at American Express Company, most recently as Senior Vice President Corporate Business Development.

George M. Tronsrue, III was appointed as a director in February 2003. Mr. Tronsrue is currently Co-Manager of Jericho Fund, LLC, an investment and consulting company. From January 2000 to March 2004, Mr. Tronsrue served as Chairman and Chief Executive Officer of Monet Mobile Networks Inc., a Seattle-based wireless Internet service provider. Monet Mobile filed for Chapter 11 bankruptcy protection in March 2004, and a U.S. trustee was appointed. From October 1997 to October 1999, Mr. Tronsrue was with XO Communications, Inc. (formerly NEXTLINK Communications, Inc.), a broadband communications company, where he served as Chief Operating Officer and was also appointed as President in July 1998. Prior to his tenure at XO Communications, Mr. Tronsrue was a member of the initial executive management team and served as Chief Operating Officer of American Communications Services, Inc. (later called e.spire Communications, Inc.), an Internet data and fiber infrastructure company. Mr. Tronsrue serves on the boards of directors of several private companies and charitable organizations.

Vanessa A. Wittman was appointed as a director in April 2003. Since March 2003, she has been Executive Vice President and Chief Financial Officer of Adelphia Communications Corporation, a cable television company. From February 2000 to March 2003, Ms. Wittman served as Chief Financial Officer of broadband network services provider 360networks Inc. 360networks filed for Chapter 11 bankruptcy protection in the U.S. and similar protection in Canada in June 2001, from which it emerged in November 2002. She served as Senior Director, Corporate Development for Microsoft Corporation from April 1999 to February 2000 and as Chief Financial Officer for Metricom, Inc., a wide-area wireless data solutions provider, from April 1997 to November 1998.

Table of Contents

ITEM 1A. Risk Factors

FACTORS AFFECTING OUR OPERATING RESULTS, BUSINESS PROSPECTS AND MARKET PRICE OF STOCK

RISKS RELATED TO OUR BUSINESS

A substantial portion of our revenues is dependent on our relationships with a small number of distribution partners who distribute our products and services, the loss of which would have a material adverse effect on our financial results.

We rely on our relationships with distribution partners, including mobile operators, Web portals and software application providers, for distribution of our products and services. We generated approximately 46% of our total revenues through relationships with our top five distribution partners for the year ended December 31, 2005. We cannot assure you that these relationships will continue or result in benefits to us that outweigh the cost of the relationships. One of our biggest challenges is providing our distribution partners with relevant products and services at competitive prices in rapidly evolving markets. In particular, our mobile operator distribution partners, including our largest distribution partner which represented approximately 28% of our total company revenues in 2005, may seek financial or competitive advantages by licensing content directly from our content providers, such as record labels, thereby reducing or eliminating the need for our products and services related to such content. In addition, other distribution partners may create their own products and services or also seek to license products and services from others that compete with or replace the products and services that we provide. Also, many of our search distribution partners are developing companies with limited operating histories and evolving business models that may prove unsuccessful even if our products and services are relevant and our prices competitive. If we are not able to maintain our relationships with these distribution partners, our financial results would be materially adversely affected.

Our mobile operator distribution partner agreements generally come up for renewal on an annual basis, and our agreements with most of our online search and directory distribution partners come up for renewal in 2006 and 2007. Such agreements may be terminated or may not be renewed or replaced on favorable terms, which could adversely impact our financial results. In particular, we are experiencing pricing pressure in our mobile business, and competition is increasing for consumer traffic in the search and directory markets. We anticipate that the cost of our content for our mobile products and services and the cost of our revenue sharing arrangements with our search distribution partners will increase as revenues grow and may increase on a relative basis compared to revenues to the extent that there are changes to existing arrangements or we enter into new arrangements on less favorable terms.

Failure by us or our distribution partners to comply with the requirements imposed by our content providers relating to the distribution of content may require us to modify, terminate or not enter into certain distribution relationships, may cause the content provider to terminate its agreement with us, and may expose us to liability.

If our search distribution partners or we fail to meet the requirements and guidelines promulgated by our major search content providers, we may not be able to continue to provide content to such distribution partners, we may be liable to such content providers for certain damages they may suffer, and the content provider may terminate its agreement with us. Certain of our search content providers have notified us that we were not in compliance with respect to our use of their content or the redistribution of their content by our distribution partners. We have been able to cure such breaches, however, there can be no assurance that if we breach our agreements in the future, we will be able to cure the breach. Our agreements with some of our major content providers give such content providers the ability to terminate their agreements with us immediately

Edgar Filing: INFOSPACE INC - Form 10-K

in the case of certain breaches, regardless of whether such breaches could be cured.

Additionally, agreements with our search content providers may be amended from time to time by both parties or may be subject to different interpretation by either party, which may require the rights we grant to our search distribution partners to be modified to comply with such amendments or interpretations. The agreements

Table of Contents

with our search distribution partners generally provide that we may modify the rights we grant to them to avoid being in conflict with the agreements with our search content providers. For example, recent changes by some of our search content providers such as Yahoo! and Google to their approval processes and guidelines with respect to downloadable applications through which content is provided to end users have resulted in some of our search distribution partners changing the manner in which they distribute their downloadable applications to end users to meet the new approval processes and guidelines. Other distribution partners have not been able to meet the new guidelines, and as a result we no longer provide the applicable content or any content, as the case may be, to such distribution partners or certain of their downloadable applications. Also, our search content providers have approval processes with respect to the redistribution of their content by our distribution partners. Some of our distribution partners that redistribute such content have not complied with such approval processes, and we no longer provide the applicable content to such partners or such partners no longer redistribute the content. If our search content providers impose additional restrictions, some of our distribution partners may be required to make changes to the manner in which they distribute their downloadable applications or may be required to cease redistributing the content. If such distribution partners are unable to meet the new restrictions, we may need to terminate our agreement with such distribution partners or no longer provide the applicable content to such partners.

The loss or reduction of content that we can make available to our distribution partners, as well as the termination of distribution or content provider agreements, for the reasons stated above, could have a material adverse effect on our financial results.

A substantial portion of our revenues is attributable to a small number of customers, the loss of any one of which would harm our financial results.

We derive a substantial portion of our revenues from a small number of customers. We expect that this concentration will continue in the foreseeable future. Our top five customers represented approximately 81%, 82% and 73% of our revenues in 2005, 2004 and 2003, respectively. Cingular Wireless, Yahoo! and Google each accounted for more than 10% of our revenues in 2005. Our principal agreements with these customers expire in 2006, 2008 and 2009, respectively. Also, some of these customers are competitors of each other, and the way we do business with one of them may not be acceptable to one or some of their competitors with whom we also do business, which may result in such competitors not renewing their agreements with us on favorable terms. If we lose any of these customers, are unable to renew the contracts on favorable terms, or any of these customers are unwilling to pay us amounts that they owe us, or dispute amounts they owe us or have paid to us, our financial results would materially suffer. Additionally, under certain of these agreements, we are required to generate a minimum amount of revenue. If we do not reach these minimums we may be required to compensate our partners for the difference between the guarantee and the shortfall. If such shortfall is substantial, it could have a material adverse effect on our financial results.

Our strategic direction is evolving, which could negatively affect our future results.

Since inception, our business model has evolved and is likely to continue to evolve as we refine our product offerings and market focus. Since 2003, we have focused on our search and directory and mobile products and services. We continue to evaluate opportunities in a rapidly evolving market. We plan to leverage our intellectual capital and core competencies to focus more on mobile applications, products and services. As part of this plan, in early 2006, we realigned our operations to a functional organization structure, eliminating the separate business units of Mobile and Search & Directory, and plan to expand our mobile media offerings, leverage our search and directory technology and applications for mobile devices, and expand our distribution channels. These changes to our business may not prove successful in the short or long term and may negatively impact our financial results.

In addition, we have in the past and may in the future find it advisable to streamline operations and reduce expenses, including, without limitation, such measures as reductions in the workforce, reductions in discretionary spending, reductions in capital expenditures as well as other steps to reduce expenses. Effecting any such

Table of Contents

restructuring would likely place significant strains on management and our operational, financial, employee and other resources. In addition, any such restructuring could impair our development, marketing, sales and customer support efforts or alter our product development plans.

We have a history of incurring net losses, we may incur net losses in the future, and we may not be able to sustain profitability on a quarterly or annual basis.

We have incurred net losses on an annual basis from our inception through December 31, 2003. As of December 31, 2005, we had an accumulated deficit of \$1.0 billion. We may incur net losses in the future including from the impairment of goodwill or other intangible assets, losses from acquisitions, restructuring charges or stock option expensing. Also, we expect to increase our operating expenditures to fund certain initiatives including new products and services and new distribution channels, such as a mobile direct to consumer business. We must therefore generate revenues sufficient to offset these expenses in order for us to be profitable. While we achieved profitability in each of our last ten fiscal quarters and on an annual basis for the fiscal years ended December 31, 2005 and 2004, we may not be able to sustain profitability on a quarterly or annual basis.

Our financial results are likely to continue to fluctuate, which could cause our stock price to be volatile or decline.

Our financial results have varied on a quarterly basis and are likely to fluctuate in the future. These fluctuations could cause our stock price to be volatile or decline. Several factors could cause our quarterly results to fluctuate materially, including:

the loss, termination or reduction in scope of key distribution or content relationships;

variable demand for our products and services, including seasonal fluctuations, rapidly evolving technologies and markets and consumer preferences;

the impact on revenues or profitability of changes in pricing for our products and services;

increased costs related to investments for new initiatives, including new products and services and new distribution channels, such as a mobile direct to consumer channel;

the results from shifts in the mix of products and services we provide;

the effects of acquisitions by us, our customers or our distribution partners;

increases in the costs or availability of content for or distribution of our products;

the adoption of new laws, rules or regulations, or new court rulings, regarding intellectual property that may adversely affect our ability to continue to acquire content and distribute our products and services, or the ability of our content providers or distribution partners to continue to provide us with their content or distribute our products and services;

Edgar Filing: INFOSPACE INC - Form 10-K

impairment in the value of long-lived assets or the value of acquired assets, including goodwill, core technology and acquired contracts and relationships;

the effect of changes in accounting principles or in our accounting treatment of revenue or expense matters;

litigation expense;

the adoption of new regulations or accounting standards, including the new accounting standard that requires us to expense the fair value of our employee stock options beginning in 2006; and

the foreign currency effects from transactions denominated in currencies other than the U.S. dollar.

For these reasons, among others, you should not rely on period-to-period comparisons of our financial results to forecast our future performance. Furthermore, our fluctuating operating results may fall below the expectations of securities analysts or investors, which could cause the trading price of our stock to decline.

Table of Contents

We operate in new and rapidly evolving markets, and our business model continues to evolve, which makes it difficult to evaluate our future prospects.

Our potential for future profitability must be considered in the light of the risks, uncertainties, and difficulties encountered by companies that are in new and rapidly evolving markets and continuing to innovate with new and unproven technologies or services, as well as undergoing significant change. Our search, directory and mobile businesses are in young industries that have undergone rapid and dramatic changes in their short history. In addition to the other risks we describe in this section, some of these risks relate to our potential inability to:

retain and expand our existing mobile operator arrangements or expand into new distribution channels;

attract and retain distribution partners for our search and directory products;

attract and retain content partners;

manage our growth, control expenditures and align costs with revenues; and

respond quickly and appropriately to competitive developments, including:

rapid technological change;

alternatives to access the Internet or mobile devices;

changes in customer requirements;

new products introduced into our markets by our competitors; and

regulatory changes affecting the industries we operate in or the markets we serve both in the United States and foreign countries.

If we do not effectively address the risks we face, we may not sustain profitability.

We depend on third parties for content, and the loss of access to or increased cost of this content could cause us to reduce our product offerings to customers and could negatively impact our financial results.

We currently create only a relatively small portion of our content. In most cases, we acquire rights to content from numerous third-party content providers, and our future success is highly dependent upon our ability to maintain relationships with these content providers and enter into new

relationships with other content providers.

We typically license content under arrangements that require us to pay usage or fixed monthly fees for the use of the content or require us to pay under a revenue-sharing arrangement. Further, our musical composition and other media licenses for the creation of mobile content consisting of ringtones generally require royalty payments on a most favored nation basis, which requires us to pay the highest royalty paid to any licensor to all such licensors. In the future, some of our content providers may not give us access to important content or may increase the royalties, fees or percentages that they charge us for their content, which could have a negative impact on our net earnings. If we fail to enter into or maintain satisfactory arrangements with content providers, our ability to provide a variety of products and services to our customers could be severely limited, thus harming our operating results. Additionally, our content license and royalty fees will increase to the extent that our revenues related to such products and services increase and may increase as a percent of revenues as a result of price competition and carrier demand for our products and services and the mix of our product sales.

Our financial and operating results will suffer if we are unsuccessful at integrating acquired technologies and businesses.

We have acquired a number of technologies and businesses in the past and may engage in further acquisitions in the future. Acquisitions may involve use of cash, potentially dilutive issuances of stock, the potential incurrence of debt and contingent liabilities or amortization expenses related to certain intangible assets.

Table of Contents

In the past, our financial results have suffered significantly due to impairment charges of goodwill and other intangible assets related to prior acquisitions. Acquisitions also involve numerous risks which could materially and adversely affect our results of operations or stock price, including:

difficulties in assimilating the operations, products, technology, information systems and personnel of acquired companies which result in unanticipated costs, delays or allocation of resources;

difficulties in acquiring foreign companies, including risks related to integrating operations across different cultures and languages, currency risks and the particular economic, political and regulatory risks associated with specific countries;

the dilutive effect on earnings per share as a result of incurring operating losses and the amortization of acquired intangible assets for the acquired business;

diverting management's attention from other business concerns;

impairing relationships with our customers or those of the acquired companies, or breaching a significant or material contract due to the consummation of the acquisition;

impairing relationships with our employees or those of the acquired companies;

failing to achieve the anticipated benefits of the acquisitions in a timely manner; and

adverse outcome of litigation matters assumed in or arising out of the acquisitions.

The success of the operations of companies that we have acquired will often depend on the continued efforts of the management and key employees of those acquired companies. Accordingly, we have typically attempted to retain key employees and members of existing management of acquired companies under the overall supervision of our senior management. We have, however, not always been successful in these attempts at retention. Failure to retain key employees of an acquired company may make it more difficult to integrate or manage the business of the acquired company, may reduce the anticipated benefits of the acquisition by increasing costs, causing delays, or otherwise and may expose us to additional competition from companies these employees may join or form.

Our stock price has been and is likely to continue to be highly volatile.

The trading price of our common stock has been highly volatile. Since we began trading on December 15, 1998, our stock price has ranged from \$3.70 to \$1,385.00 (as adjusted for stock splits). On February 17, 2006, the closing price of our common stock was \$23.41. Our stock price could decline or be subject to wide fluctuations in response to factors such as the other risks discussed in this section and the following, among others:

actual or anticipated variations in quarterly and annual results of operations;

Edgar Filing: INFOSPACE INC - Form 10-K

announcements of significant acquisitions, dispositions, changes in material contracts or other business developments by us, our customers, distribution partners or competitors;

conditions or trends in the search, directory or mobile products and services markets;

announcements of technological innovations, new products or services, or new customer or partner relationships by us or our competitors;

changes in financial estimates or recommendations by securities analysts;

disclosures of any material weaknesses in internal control over financial reporting;

the adoption of new regulations or accounting standards, including the new accounting standard that requires us to expense the fair value of our employee stock options beginning in 2006; and

announcements or publicity relating to litigation and similar matters.

In addition, the stock market in general, and the Nasdaq National Market and the market for Internet and technology company securities in particular, have experienced extreme price and volume fluctuations. These

Table of Contents

broad market and industry factors and general economic conditions may materially and adversely affect our stock price. Our stock has been subject to such price and volume fluctuations in the recent past. Often, class action litigation has been instituted against companies after periods of volatility in the overall market and the price of such companies' stock. If such litigation were to be instituted against us, even if we were to prevail, it could result in substantial cost and diversion of management's attention and resources.

Our search and directory products and services may expose us to claims relating to how the content was obtained or distributed.

Our search and directory services link users, either directly through our Web sites or indirectly through the Web properties of our distribution partners, to third party Web pages and content in response to search queries. These services could expose us to legal liability from claims relating to such third-party content and sites, the manner in which these services are distributed by us or our distribution partners, or how the content provided by our third-party content providers was obtained or provided by our content providers. Such claims could include the following: infringement of copyright, trademark, trade secret or other proprietary rights; violation of privacy and publicity rights; unfair competition; defamation; providing false or misleading information; obscenity; and illegal gambling. Regardless of the legal merits of any such claims, they could result in costly litigation, be time consuming to defend and divert management's attention and resources. If there were a determination that we had violated third-party rights or applicable law, we could incur substantial monetary liability, be required to enter into costly royalty or licensing arrangements (if available), or be required to change our business practices. Implementing measures to reduce our exposure to such claims could require us to expend substantial resources and limit the attractiveness of our products and services to our customers. As a result, these claims could result in material harm to our business.

Recently, there have been legal actions brought or threatened against distributors of downloadable applications deemed to be adware or spyware. Additionally, certain bills are pending and some laws have been passed in certain jurisdictions setting forth requirements that must be met before a downloadable application is downloaded to an end user's computer. We partner with some distribution partners that provide adware to their users if the partners adhere to our strict guidelines requiring them, among other things, to disclose to the user what the adware does and to obtain the consent of the user before the application is downloaded. The adware must also be easy to uninstall. We also review the application the partner proposes to use before we distribute our results to them. We also have the right to audit our partners, and if we find that they are not following our guidelines, we can terminate our agreement with them or cease providing content to that downloadable application. Some partners have not been able to meet the new guidelines imposed by us or some of our content providers, and we no longer provide the applicable content or any content, as the case may be, to such partners or certain of their downloadable applications. We work closely with some of our major content providers to try to identify potential distribution partners that do not meet our guidelines or are in breach of our distribution agreements and we work with our distribution partners to ensure they deliver quality traffic. However, there can be no assurance that the measures we implement to reduce our exposure to claims that certain ways in which the content is distributed violate legal requirements will be successful. As stated above, these claims could result in material harm to our business.

Our efforts to increase our presence in markets outside the United States may be unsuccessful and could result in losses.

We plan to expand our mobile and search offerings internationally, particularly in Europe. We have limited experience in marketing and operating our products and services in international markets, and we may not be able to successfully execute our business model in these markets. Our success in these markets will be directly linked to the success of relationships with our distribution and content partners and other third parties.

As the international markets in which we operate continue to grow, competition in these markets will intensify. Local companies may have a substantial competitive advantage because of their greater understanding

Table of Contents

of and focus on the local markets. Some of our domestic competitors who have substantially greater resources than we do may be able to more quickly and comprehensively develop and grow in the international markets. International expansion may also require significant financial investment including, among other things, the expense of developing localized products, the costs of acquiring foreign companies and the integration of such companies with our operations, expenditure of resources in developing distribution and content relationships and the increased costs of supporting remote operations. Although our revenues from our European offerings have increased in absolute dollars, they have remained relatively the same as a percentage of our overall revenues.

Other risks of doing business in international markets include the increased risks and burdens of complying with different legal and regulatory standards, difficulties in managing and staffing foreign operations, limitations on the repatriation of funds and fluctuations of foreign exchange rates, varying levels of Internet technology adoption and infrastructure, and ability to enforce our contracts in foreign jurisdictions. In addition, our success in international expansion could be limited by barriers to international expansion such as tariffs, adverse tax consequences, and technology export controls. If we cannot manage these risks effectively, the costs of doing business in some international markets may be prohibitive or our costs may increase disproportionately to our revenues.

We have implemented anti-takeover provisions that could make it more difficult to acquire us.

Our certificate of incorporation, bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors, even if the transaction would be beneficial to our stockholders. Provisions of our charter documents which could have an anti-takeover effect include:

the classification of our board of directors into three groups so that directors serve staggered three-year terms, which may make it difficult for a potential acquirer to gain control of our board of directors;

the ability to authorize the issuance of shares of undesignated preferred stock without a vote of stockholders;

a prohibition on stockholder action by written consent; and

limitations on stockholders' ability to call special stockholder meetings.

On July 19, 2002, our board of directors adopted a stockholder rights plan, pursuant to which we declared and paid a dividend of one right for each share of common stock held by stockholders of record as of August 9, 2002. Unless redeemed by us prior to the time the rights are exercised, upon the occurrence of certain events, the rights will entitle the holders to receive shares of our preferred stock, or shares of an acquiring entity. The issuance of the rights would make the acquisition of InfoSpace more expensive to the acquirer and could delay or discourage third parties from acquiring InfoSpace without the approval of our board of directors.

Our systems could fail or become unavailable, which could harm our reputation, result in a loss of current and potential customers and cause us to breach agreements with our partners.

Edgar Filing: INFOSPACE INC - Form 10-K

Our success depends, in part, on the performance, reliability and availability of our services. We have data centers in Seattle and Bellevue, Washington; Los Angeles, California; Waltham, Massachusetts; Papendrecht, The Netherlands; and Hamburg, Germany. Although we have completed our disaster and redundancy planning for certain of our business critical systems so that some are now redundant across two physical locations, we have not yet completed our disaster recovery and redundancy planning for others. Our systems and operations could be damaged or interrupted by fire, flood, power loss, telecommunications failure, Internet breakdown, break-in, earthquake or similar events. We would face significant damage as a result of these events, and our business interruption insurance may not be adequate to compensate us for all the losses that may occur. In addition, our systems use sophisticated software that may contain bugs that could interrupt service. For these reasons, we may be unable to develop or successfully manage the infrastructure necessary to meet current or future demands for reliability and scalability of our systems.

Table of Contents

If the volume of traffic to our products and services increases substantially, we must respond in a timely fashion by expanding our systems, which may entail upgrading our technology and network infrastructure. Due to the number of our customers and the products and services that we offer, we could experience periodic capacity constraints which may cause temporary unanticipated system disruptions, slower response times and lower levels of customer service. Our business could be harmed if we are unable to accurately project the rate or timing of increases, if any, in the use of our products and application services or expand and upgrade our systems and infrastructure to accommodate these increases in a timely manner.

Furthermore, we have entered into service level agreements with most of our mobile operator customers and certain other customers. These agreements generally call for specific system up times and 24/7 support and include penalties for non-performance. We may be unable to fulfill these commitments, which could subject us to penalties under those agreements, harm our reputation and result in the loss of customers and distribution partners.

The security measures we have implemented to secure information we collect and store may be breached, which could cause us to breach agreements with our partners and expose us to potential investigation and penalties by authorities and potential claims by persons whose information was disclosed.

We take reasonable steps to protect the security, integrity and confidentiality of the information we collect and store but there is no guarantee that inadvertent or unauthorized disclosure will not occur or that third parties will not gain unauthorized access despite our efforts. If such unauthorized disclosure or access does occur, we may be required to notify persons whose information was disclosed or accessed under existing and proposed laws. We also may be subject to claims of breach of contract for such disclosure, investigation and penalties by regulatory authorities and potential claims by persons whose information was disclosed.

We may be subject to liability for our use or distribution of information that we gather or receive from third parties.

We obtain content and commerce information from third parties. When we distribute this information, we may be liable for the data that is contained in that content. This could subject us to legal liability for such things as defamation, negligence, intellectual property infringement, violation of privacy or publicity rights and product or service liability, among others. Laws or regulations of certain jurisdictions may also deem some content illegal, which may expose us to legal liability as well. We also gather personal information from users in order to provide personalized services. Gathering and processing this personal information may subject us to legal liability for, among other things, negligence, defamation, invasion of privacy or product or service liability. We are also subject to laws and regulations, both in the United States and abroad, regarding the collection and use of end user information. If we do not comply with these laws and regulations, we may be exposed to legal liability.

Many of the agreements by which we obtain content do not contain indemnity provisions in favor of us. Even if a given contract does contain indemnity provisions, these provisions may not cover a particular claim or type of claim or the party giving the indemnity may not have the financial resources to cover the claim. Our insurance coverage may be inadequate to cover fully the amounts or types of claims that might be made against us. Any liability that we incur as a result of content we receive from third parties could harm our financial results.

If others claim that our products infringe their intellectual property rights, we may be forced to seek expensive licenses, reengineer our products, engage in expensive and time-consuming litigation or stop marketing and licensing our products.

Edgar Filing: INFOSPACE INC - Form 10-K

We attempt to avoid infringing known proprietary rights of third parties in our product development efforts. However, we do not regularly conduct patent searches to determine whether the technology used in our products infringes patents held by third parties. Patent searches generally return only a fraction of the issued patents that may be deemed relevant to a particular product or service. It is therefore nearly impossible to determine, with any level of certainty, whether a particular product or service may be construed as infringing a U.S. or foreign patent. Because patent applications in the United States are not publicly disclosed until the patent is issued, applications

Table of Contents

may have been filed by third parties that relate to our products. In addition, other companies, as well as research and academic institutions, have conducted research for many years in the search and directory and mobile and wireless technology fields, and this research could lead to the filing of further patent applications.

In addition to patent claims, third parties may make claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy or publicity rights. In some cases, the ownership or scope of an entity's or person's rights is unclear and may also change over time.

If we were to discover that our products violated or potentially violated third-party proprietary rights, we might be required to obtain licenses that are costly or contain terms unfavorable to us, or expend substantial resources to reengineer those products so that they would not violate such third party rights. Any reengineering effort may not be successful, and we cannot be certain that any such licenses would be available on commercially reasonable terms. Any third-party infringement claims against us could result in costly litigation and be time consuming to defend, divert management's attention and resources, cause product and service delays or require us to enter into royalty and licensing agreements.

If we fail to detect invalid click activity, we could lose the confidence of advertisers and of our content providers, which would cause our business to suffer.

Most of our revenues from our search and directory business are based on the number of paid clicks on commercial search results served on our own Web sites or our distribution partners' Web properties. Generally, each time a user clicks on a commercial search result, the content provider that provided the commercial search result receives a fee from the advertiser who paid for such commercial click and the content provider pays us a portion of that fee. If the click originated from one of our distribution partners' Web properties, we share a portion of the fee we receive with such partner. This model exposes us to the risk of invalid click activity. Such invalid click activity occurs, for example, when a person or automated click generation program clicks on a commercial search result to generate fees for the Web property displaying the commercial search result rather than to view the Web page underlying the commercial search result or when a competitor of the advertiser clicks on the advertiser's search result to increase the advertising expense of the advertiser. When such invalid click activity is detected, content providers may refund the fee paid by the advertiser for such invalid clicks. When such invalid click activity is detected as coming from one of our distribution partners' Web properties or our own Web sites, our content providers may refund the fees paid by the advertisers for such invalid clicks, which in turn reduces the amount of fees the content provider pays us. If we or our content providers are unable to effectively detect and stop invalid click activity, advertisers may see a reduced return on their advertising investment with the content provider because such invalid clicks will not lead to potential revenue for such advertisers, which could lead such advertisers to reduce or terminate their investment in such ads. This could lead to a loss of advertisers and revenue to our content providers and consequently to fewer fees paid to us. Additionally, if we are unable to detect and stop invalid click activity that may originate from our own Web sites or the Web properties of our distribution partners, our content providers may impose restrictions on our ability to provide their commercial search results on our own Web sites or to our current and future distribution partners, which could have a materially negative impact on our financial results. Although we and our content providers have in place certain systems to assist with the detection of invalid clicks, these systems may not detect all such invalid click activity.

We rely heavily on our technology, but we may be unable to adequately or cost-effectively protect or enforce our intellectual property rights, thus weakening our competitive position and negatively impacting our financial results.

To protect our rights in our products and technology, we rely on a combination of copyright and trademark laws, patents, trade secrets, and confidentiality agreements with employees and third parties and protective contractual provisions. We also rely on the law pertaining to trademarks and domain names to protect the value of our corporate brands and reputation. Despite our efforts to protect our proprietary rights, unauthorized parties

Table of Contents

may copy aspects of our products or services or obtain and use information that we regard as proprietary, or infringe our trademarks. In addition, it is possible that others could independently develop substantially equivalent intellectual property. If we do not effectively protect our intellectual property, we could lose our competitive position.

Effectively policing the unauthorized use of our products and trademarks is time-consuming and costly, and there can be no assurance that the steps taken by us will prevent misappropriation of our technology or trademarks. Our intellectual property may be subject to even greater risk in foreign jurisdictions, as protection is not sought or obtained in every country in which our services are available. Also, the laws of many countries do not protect proprietary rights to the same extent as the laws of the United States. If we cannot adequately protect our intellectual property, our competitive position in markets abroad may suffer.

If we are unable to retain our key employees, we may not be able to successfully manage our business.

Our business and operations are substantially dependent on the performance of our executive officers and key employees, who are employed on an at-will basis. If we lose the services of one or more of our executive officers or key employees and are unable to recruit and retain a suitable successor(s), we may not be able to successfully manage our business or achieve our business objectives.

Unless we are able to hire, retain and motivate highly qualified employees, we will be unable to execute our business strategy.

Our future success depends on our ability to identify, attract, hire, retain and motivate highly skilled technical, managerial, sales and marketing, and corporate development personnel. Our services and the industries to which we provide our services are relatively new. Qualified personnel with experience relevant to our business are scarce and competition to recruit them is intense. If we fail to successfully hire and retain a sufficient number of highly qualified employees, we may have difficulties in supporting our customers or expanding our business. Additional realignments of resources, reductions in workforce or other future operational decisions could create an unstable work environment and may have a negative effect on our ability to retain and motivate employees.

In light of current market and regulatory conditions, the value of stock options granted to employees may cease to provide sufficient incentive to our employees.

Like many technology companies, we use stock options to recruit technology professionals and senior level employees. Our stock options, which typically vest over a four-year period, are one of the means by which we motivate long-term employee performance. Recent changes in accounting treatment of options requiring us to expense the fair value of our employee stock options beginning in 2006 may make it difficult or overly expensive for us to issue stock options to our employees in the future. We also face a significant challenge in retaining our employees if the value of these stock options is either not substantial enough or so substantial that the employees leave after their stock options have vested. If our stock price does not increase significantly above the prices of our options, or option programs become impracticable, we may need to issue new options or other equity incentives or increase other forms of compensation to motivate and retain our employees. We may undertake or seek stockholder approval to undertake programs to retain our employees, which may be viewed as dilutive to our stockholders or may increase our compensation costs. Additionally, there can be no assurance that any such programs we undertake will be successful in motivating and retaining our employees.

RISKS RELATED TO THE INDUSTRIES IN WHICH WE OPERATE

Intense competition in the mobile, search, and directory markets could prevent us from increasing distribution of our services in those markets or cause us to lose market share.

Our current business model depends on distribution of our products and services into the wireless and search and directory markets, which are extremely competitive and rapidly changing. Many of our competitors have substantially greater financial, technical and marketing resources, larger customer bases, longer operating histories, more developed infrastructures, greater name recognition or more established relationships in the

Table of Contents

industry than we have. Our competitors may be able to adopt more aggressive pricing policies, develop and expand their service offerings more rapidly, adapt to new or emerging technologies and changes in customer requirements more quickly, take advantage of acquisitions and other opportunities more readily, achieve greater economies of scale, and devote greater resources to the marketing and sale of their services than we can. Because of these competitive factors and due to our relatively small size and financial resources, we may be unable to compete successfully.

Some of the companies we compete with are currently customers of ours, the loss of which could harm our business. Many of our customers have established relationships with some of our competitors. If these competitors develop products and services that compete with ours, we could lose market share and our revenues could decrease. Additionally, our financial results could be adversely affected as well if our distribution partners create their own products and services that compete or replace the products and services we provide.

Consolidation in the industries in which we operate could lead to increased competition and loss of customers.

The Internet industry (including the search and directory segments) and the wireless industry have experienced substantial consolidation. We expect this consolidation to continue. These acquisitions could adversely affect our business and results of operations in a number of ways, including the following:

our distribution partners could acquire or be acquired by one of our competitors and terminate their relationship with us;

our distribution partners could merge with each other, which could reduce our ability to negotiate favorable terms;

competitors could improve their competitive positions through strategic acquisitions; and

companies from whom we acquire content could acquire or be acquired by one of our competitors and stop licensing content to us, or gain additional negotiating leverage in their relationships with us.

Security breaches may pose risks to the uninterrupted operation of our systems.

Our networks may be vulnerable to unauthorized access by hackers or others, computer viruses and other disruptive problems. Someone who is able to circumvent security measures could misappropriate our proprietary information or cause interruptions in our operations. Subscribers to some of our services are required to provide information in order to utilize the service that may be considered to be personally identifiable or private information. Unauthorized access to, and abuse of, this information could subject us to a risk of loss or litigation and liability.

We may need to expend significant capital or other resources protecting against the threat of security breaches or alleviating problems caused by breaches. Although we intend to continue to implement and improve our security measures, persons may be able to circumvent the measures that we implement in the future. Eliminating computer viruses and alleviating other security problems may require interruptions, delays or cessation of service to users accessing our services, any of which could harm our business.

Governmental regulation and the application of existing laws may slow business growth, increase our costs of doing business and create potential liability.

The growth and development of the Internet and wireless communication have led to new laws and regulations, as well as the application of existing laws to wireless communications and the Internet. Application of these laws can be unclear. The costs of complying or failure to comply with these laws and regulations could limit our ability to operate in our markets, expose us to compliance costs and substantial liability and result in costly and time-consuming litigation.

Table of Contents

Several federal or state laws could impact our business. Federal laws include those designed to restrict the online distribution of certain materials deemed harmful to children and impose additional restrictions or obligations for online services when dealing with minors. Such legislation may impose significant additional costs on our business or subject us to additional liabilities. The application to advertising in our industries of existing laws regulating or requiring licenses for certain businesses can be unclear. Such regulated businesses may include, for example, gambling; distribution of pharmaceuticals, alcohol, tobacco or firearms; or insurance, securities brokerage and legal services. Additionally, certain bills are pending and some laws have been passed in certain jurisdictions setting forth requirements that must be met before a downloadable application is downloaded to an end user's computer.

We post our privacy policies and practices concerning the use and disclosure of user data. Any failure by us to comply with our posted privacy policies, Federal Trade Commission (the "FTC") requirements or other privacy-related laws and regulations could result in proceedings by the FTC or others which could potentially have an adverse effect on our business, results of operations and financial condition. In this regard, there are a large number of legislative proposals before the United States Congress and various state legislative bodies regarding privacy issues related to our business. It is not possible to predict whether or when such legislation may be adopted, and certain proposals, if adopted, could materially and adversely affect our business through a decrease in user registrations and revenues. This could be caused by, among other possible provisions, the required use of disclaimers or other requirements before users can utilize our services.

The FTC has recommended to search engine providers that paid-ranking search results be delineated from non-paid results. To the extent that the FTC may in the future issue specific requirements regarding the nature of such delineation, which would require modifications to the presentation of search results, revenue from the affected search engines could be negatively impacted.

Due to the nature of the Internet, it is possible that the governments of states and foreign countries might attempt to regulate Internet transmissions or institute proceedings for violations of their laws. We might unintentionally violate such laws, such laws may be modified and new laws may be enacted in the future. Any such developments (or developments stemming from enactment or modification of other laws) could increase the costs of regulatory compliance for us or force us to change our business practices.

We rely on the infrastructure of the Internet and of wireless networks, over which we have no control and the failure of which could substantially undermine our operations.

Our success depends, in large part, on other companies maintaining the Internet system infrastructure and mobile operators who distribute our mobile content and services to maintain their proprietary wireless networks. In particular, with respect to the Internet, we rely on other companies to maintain a reliable network backbone that provides adequate speed, data capacity and security and to develop products that enable reliable Internet access and services. With respect to wireless networks, we depend on mobile operators to maintain their wireless networks so as to provide adequate speed, data capacity and security and that enable reliable mobile access to our products and services.

As the Internet and usage of mobile services continues to experience growth in the number of users, frequency of use and amount of data transmitted, the Internet system infrastructure and the wireless networks of mobile operators may be unable to support the demands placed on them, and the Internet's and mobile operators' networks performance or reliability may suffer as a result of this continued growth. Some of the companies that we rely upon to maintain network infrastructure may lack sufficient capital to support their long-term operations. The failure of the internet infrastructure or wireless networks would substantially undermine our operations and may have a material adverse effect on our financial results.

ITEM 1B. Unresolved Staff Comments

Not applicable.

Table of Contents

ITEM 2. Properties

Our principal corporate office is located in Bellevue, Washington, and we have business operations in: Los Angeles and San Mateo, California; Waltham and Westborough, Massachusetts; Woking and Eastleigh, United Kingdom; Papendrecht, The Netherlands; and Hamburg, Germany. Our Bellevue and Woking facilities are utilized by both our Search & Directory and Mobile businesses; our Westborough facilities are utilized by our Search & Directory business; and our Los Angeles, San Mateo, Eastleigh, Papendrecht and Hamburg facilities are utilized by our Mobile business. We have data centers in Bellevue and Seattle, Washington, Los Angeles, California, Waltham, Massachusetts, Papendrecht, The Netherlands, and Hamburg, Germany. All of our facilities are leased. We believe our properties are suitable and adequate for our present and anticipated near term needs.

ITEM 3. Legal Proceedings

See Note 8 Commitments and Contingencies of the Notes to Consolidated Financial Statements (Item 8) for information regarding legal proceedings.

ITEM 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Table of Contents**PART II****ITEM 5. Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities****Market for Our Common Stock**

Our common stock has been traded on the Nasdaq National Market under the symbol INSP since December 15, 1998, the date of our initial public offering. Prior to that time, there was no public market for our common stock. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported by the Nasdaq National Market.

	High	Low
Fiscal Year Ending December 31, 2005:		
First Quarter	\$ 48.70	\$ 36.68
Second Quarter	\$ 46.60	\$ 28.90
Third Quarter	\$ 36.81	\$ 21.90
Fourth Quarter	\$ 28.42	\$ 21.36
Fiscal Year Ending December 31, 2004:		
First Quarter	\$ 40.87	\$ 23.05
Second Quarter	\$ 45.85	\$ 30.00
Third Quarter	\$ 48.50	\$ 26.50
Fourth Quarter	\$ 57.92	\$ 43.02

On February 17, 2006, the last reported sale price for our common stock on the Nasdaq National Market was \$23.41 per share. As of February 17, 2006, there were approximately 1,000 holders of record of our common stock.

We have never declared, nor have we paid, any cash dividends on our common stock. We currently intend to retain our earnings to finance future growth and, therefore, do not anticipate paying any cash dividends on our common stock in the foreseeable future. Please see Part III, Item 12 of this report for disclosure relating to our equity compensation plans. Such information is incorporated by reference from our Proxy Statement.

Issuer Purchases of Equity Securities

We have a stock repurchase plan that authorizes us to purchase up to \$100 million of our common stock in open-market transactions through May 12, 2006. The following are details of repurchases under this plan and outside of this plan for the fourth quarter of 2005:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Dollar Value that May Yet be Purchased Under the Plan
October 1, 2005 through October 31, 2005		\$		\$ 37,798,143
November 1, 2005 through November 30, 2005	304,039	\$ 26.67	300,000	\$ 29,801,043

Edgar Filing: INFOSPACE INC - Form 10-K

December 1, 2005 through December 31, 2005	\$		\$ 29,801,043
Total	304,039	\$ 26.67	300,000

-
- (1) On May 13, 2005, our Board of Directors approved a stock repurchase plan that authorizes us to purchase up to \$100 million of our common stock in open-market transactions through May 12, 2006. The plan was announced on May 16, 2005. A total of 300,000 were purchased under this plan in the fourth quarter of 2005. Repurchased shares are retired and resume the status of authorized but unissued shares of common stock. Our Board of Directors also authorized that the stock purchases may be made pursuant to a plan under Rule 10b5-1 of the Securities Exchange Act of 1934, as amended. No repurchases under a 10b5-1 plan were made during the fourth quarter of 2005. An additional 4,039 shares were purchased outside of the repurchase plan on November 23, 2005 from two shareholders at a price of \$27.81 per share, which was the closing price of our stock on such date as reported by Nasdaq. The shares were repurchased in privately negotiated transactions from two shareholders who originally received the shares in February 2005 in connection with an exchange of exchangeable shares of Locus Dialogue, Inc., a Canadian subsidiary that we acquired in 2001, for our shares. The repurchased shares were retired and resumed the status of authorized but unissued shares of common stock and no additional repurchases of such shares are contemplated.

Table of Contents**ITEM 6. Selected Consolidated Financial Data**

The following selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, our consolidated financial statements and notes thereto and other financial information included elsewhere in this report. The selected consolidated statements of operations data for the years ended December 31, 2005, 2004, 2003, 2002 and 2001 are derived from our audited consolidated financial statements.

	Years Ended December 31,				
	2005	2004	2003	2002	2001 (1)
	(in thousands, except per share data)				
Consolidated Statements of Operations Data:					
Revenues	\$ 339,968	\$ 249,354	\$ 132,230	\$ 114,972	\$ 146,565
Operating expenses:					
Content and distribution	145,351	92,688	27,583	15,026	20,568
Systems and network operations	21,375	14,220	10,988	16,101	24,587
Product development	31,203	23,142	17,781	29,128	36,631
Sales and marketing	31,062	23,486	17,487	19,433	32,889
General and administrative	40,234	36,348	32,225	42,687	52,517
Depreciation	9,061	6,974	10,819	18,089	18,733
Amortization of intangible assets	15,265	9,920	6,819	12,854	199,777
Impairment of goodwill and other intangible assets			1,151	76,385	107,729
Acquisition and related charges					(3,504)
Restructuring charges		222	11,722	1,814	17,392
Other, net		(3,203)	1,529	4,167	11,505
Total operating expenses	293,551	203,797	138,104	235,684	518,824
Operating income (loss)	46,417	45,557	(5,874)	(120,712)	(372,259)
Gain (loss) on investments	154	425	(11,997)	(20,940)	(108,158)
Other income, net (2)	89,322	4,991	8,190	6,932	16,902
Income (loss) from continuing operations before minority interest, income taxes, discontinued operations and cumulative effect of change in accounting principle	135,893	50,973	(9,681)	(134,720)	(463,515)
Minority interest					(17)
Income tax benefit (expense)	23,475	29	607	(430)	(664)
Income (loss) from continuing operations before discontinued operations and cumulative effect of change in accounting principle	159,368	51,002	(9,074)	(135,150)	(464,196)
Discontinued operations (3):					
Income (loss) from discontinued operations, net of taxes		2,277	2,755	(3,481)	(34,712)
Gain on sale of discontinued operations, net of taxes		29,122			
Cumulative effect of change in accounting principle (4)				(206,619)	(3,171)
Net income (loss)	\$ 159,368	\$ 82,401	\$ (6,319)	\$ (345,250)	\$ (502,079)
Basic income (loss) per share:					
Income (loss) from continuing operations	\$ 4.94	\$ 1.59	\$ (0.29)	\$ (4.41)	\$ (14.59)
Income (loss) from discontinued operations		0.98	0.09	(0.11)	(1.09)
Cumulative effect of change in accounting principle				(6.74)	(0.10)
Basic net income (loss) per share	\$ 4.94	\$ 2.57	\$ (0.20)	\$ (11.26)	\$ (15.78)

Edgar Filing: INFOSPACE INC - Form 10-K

Shares used in computing basic net income (loss) per share	32,284	32,109	31,232	30,656	31,822
Diluted income (loss) per share:					
Income (loss) from continuing operations	\$ 4.47	\$ 1.40	\$ (0.29)	\$ (4.41)	\$ (14.59)
Income (loss) from discontinued operations		0.86	0.09	(0.11)	(1.09)
Cumulative effect of change in accounting principle				(6.74)	(0.10)
Diluted net income (loss) per share	\$ 4.47	\$ 2.26	\$ (0.20)	\$ (11.26)	\$ (15.78)
Shares used in computing diluted net income (loss) per share	35,616	36,541	31,232	30,656	31,822

Table of Contents

	2005	2004	As of December 31,		2001
			2003	2002	
			(in thousands)		
Consolidated Balance Sheet Data:					
Cash, cash equivalents, short-term and long-term investments	\$ 375,373	\$ 321,814	\$ 295,323	\$ 276,218	\$ 293,771
Working capital	397,669	309,411	353,659	287,228	199,897
Total assets	743,379	626,094	492,315	481,396	837,005
Total stockholders' equity	664,971	562,396	446,532	448,136	782,588

- (1) The share amounts for this year have been retroactively adjusted to give effect to the one-for-ten reverse stock split of our common stock consummated in September 2002.
- (2) In 2005, we received proceeds of \$83.2 million from the settlement of several outstanding litigation matters and recognized a gain of \$79.3 million comprised of the settlement proceeds and interest, less \$3.9 million in legal fees.
- (3) We consummated the sale of our Payment Solutions business on March 31, 2004, and the operating results and gain from the sale of this business have been presented as discontinued operations for all periods presented.
- (4) We adopted Statement of Financial Accounting Standard (SFAS) No. 142, *Goodwill and Other Intangible Assets* on January 1, 2002. We recorded a non-cash charge for the cumulative effect of change in accounting principle of \$206.6 million as of January 1, 2002, which was related to impairment of goodwill. This amount was determined based on an independent valuation of our reporting units as of January 1, 2002 using a combination of our quoted stock price and projections of future discounted cash flows for each reporting unit. On January 1, 2001, we adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. We recorded a charge of \$3.2 million to record warrants held to purchase stock in other companies at their fair value as of January 1, 2001 as a cumulative effect of change in accounting principle.

Table of Contents

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion and analysis in conjunction with Selected Consolidated Financial Data and our consolidated financial statements and notes thereto included elsewhere in this report. In addition to historical information, the following discussion contains forward-looking statements that involve known and unknown risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. You should read the cautionary statements made in this report. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and in the section entitled Item 1A. Risk Factors Factors Affecting Our Operating Results, Business Prospects and Market Price of Stock, as well as those discussed elsewhere herein. You should not rely on these forward-looking statements, which reflect only our opinion as of the date of this report.

Overview

InfoSpace, Inc. (InfoSpace , Our or We) is a provider and publisher of mobile content, products and services that enhance the wireless experience, assisting consumers with finding information, personalization and entertainment on the mobile phone. We also use our metasearch technology to power our own branded Web sites and provide private-label online search and directory services to distribution partners. We were founded in 1996 and are incorporated in the state of Delaware. Our principal corporate office is located in Bellevue, Washington. We also have facilities in Los Angeles and San Mateo, California; Westborough, Massachusetts; Woking and Eastleigh, United Kingdom; Papendrecht, The Netherlands; and Hamburg, Germany. Our common stock is listed on the Nasdaq Stock Market under the symbol INSP.

In 2003 and 2004, we tightened our strategic focus to two businesses: Mobile and Search & Directory. We sold our Payment Solutions business for \$82.0 million in cash and sold or otherwise disposed of other non-core services, expanded both our Mobile and Search & Directory businesses, which included the acquisition of complimentary businesses, including mobile content and application businesses and an online directory company. We plan to leverage our intellectual capital and core competencies to focus more on mobile applications, products, and services. As part of this plan, in early 2006, we realigned our operations to a functional organization structure, eliminating the separate business units, and plan to expand our mobile media offerings, leverage our online search and directory technology and applications for mobile devices, and expand our distribution channels.

Our Mobile business provides media products and content to mobile operators and portal and infrastructure services that enable mobile operators to deliver content and programming across multiple devices to their subscribers. Through our products, content and service offerings, our mobile operator partners are able to aggregate, configure and customize the services they offer under their own brand and deliver them to their subscribers.

Our search and directory services enable Internet users to locate information, merchants, individuals and products online. We offer search and directory services through our branded Web sites, Dogpile.com, Switchboard.com, InfoSpace.com, Webcrawler.com and MetaCrawler.com, as well as through the Web properties of distribution partners. Partner versions of our search and directory services are generally private-labeled and delivered with each distribution partner's unique requirements.

Overview of 2005 Operating Results

Edgar Filing: INFOSPACE INC - Form 10-K

The following is an overview of our operating results for the year ended December 31, 2005. A more detailed discussion of our operating results, comparing our operating results for the years ended December 31, 2005, 2004 and 2003, is included under the heading "Historical Results of Operations" in this Management's Discussion and Analysis of Financial Condition and Results of Operations.

Revenues for the year ended December 31, 2005 increased to \$340.0 million from \$249.4 million for the year ended December 31, 2004.

Table of Contents

Revenues from our Mobile business increased to \$157.4 million in the year ended December 31, 2005 from \$92.5 million in the year ended December 31, 2004, primarily attributable to an increase in sales of our media download products, such as ringtones and graphics and, to a lesser extent, sales of games as a result of our acquisition in the second half of 2004 and early 2005 of three mobile gaming companies.

Revenues from our Search & Directory business increased to \$182.6 million for the year from \$156.8 million in 2004. The increase was primarily attributable to the growth in search revenues from our search distribution business, in which we private label our search products for others to offer on their own Web properties, and, to a lesser extent, directory revenues as a result of a contract with Yellowpages.com in June 2005 and partially from a full year of results from an online directory business we acquired in June 2004. This increase was offset by a decline in directory revenues due to one of our top ten customers, Verizon, not renewing certain key provisions of our subscription agreement for yellow page listings in June 2005. During the year ended December 31, 2005, over 60% of our search revenues in North America came from our search distribution partners.

Total operating expenses for the year ended December 31, 2005 were \$293.6 million, an increase of \$89.8 million from operating expenses of \$203.8 million for the year ended December 31, 2004. The increase was primarily attributable to an increase in our content costs associated with our media download products and distribution costs for revenue share amounts due to our Search & Directory distribution partners. We expect these costs, in absolute dollars, to increase as revenues from these products and services increase. Additionally, these costs, as a percentage of revenue, increased at a greater rate due to the shift in the mix of products and services we provided. In particular, sales of our labeltones or MP3-like quality ringtones, for which our costs as a percentage of revenue are greater than our other media download products, represented a larger share of our Mobile revenues. Other operating costs increased as we expanded our operations, including increases in personnel costs, which include salaries, benefits and other employee costs, and costs of temporary help from contractors to augment our staffing needs, resulting from additional headcount related to the growth in our business and our acquisitions in 2004 and early 2005. Our marketing and advertising costs also increased. Additionally, amortization of intangible assets and depreciation increased as a result of our acquisitions.

In 2005, we recognized a gain, net of legal costs, of \$79.3 million in connection with the settlement of certain litigation matters, including the *Dreiling v. Jain, et al.* derivative lawsuit and the *Dreiling v. Jain, et al.* Section 16(b) case. We also recognized an income tax benefit of \$25.0 million from the realization of a deferred tax asset related to a portion of our net operating loss carryforward. Additionally, interest income increased in 2005 to \$11.3 million compared to interest income in 2004 of \$4.7 million and was primarily attributable to an increase in interest rates and, to a lesser extent, more available cash and marketable investments on hand to invest. In 2004, we recorded income from discontinued operations of \$31.4 million as a result of the gain of \$29.1 million on the sale of Payment Solutions and income of \$2.3 million from the Payment Solutions business during the first quarter of 2004.

Net income for the year ended December 31, 2005 was \$159.4 million compared to net income of \$82.4 million in the year ended December 31, 2004, which increase was primarily attributable to the items noted above.

Critical Accounting Policies and Estimates

The Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as disclosures included elsewhere in this Form 10-K, are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and disclosures of contingencies.

Edgar Filing: INFOSPACE INC - Form 10-K

The SEC has defined a company's most critical accounting policies as the ones that are the most important to the portrayal of the company's financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. On an ongoing basis, we evaluate the estimates used, including those related to impairment of goodwill and other intangible assets, useful lives of other intangible assets, purchase accounting,

Table of Contents

other-than-temporary impairment of investments, revenue recognition, the estimated allowance for sales returns and doubtful accounts, restructuring-related liabilities, accrued contingencies and valuation allowance for our deferred tax assets. We base our estimates on historical experience, current conditions and on various other assumptions that we believe to be reasonable under the circumstances and, based on information available to us at that time, we make judgments about the carrying values of assets and liabilities that are not readily apparent from other sources as well as identify and assess our accounting treatment with respect to commitments and contingencies. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions. We believe the following critical accounting policies involve the more significant judgments and estimates used in the preparation of our consolidated financial statements. We also have other accounting policies, which involve the use of estimates, judgments and assumptions that are significant to understanding our results. For additional information see Item 8 of Part II Financial Statements and Supplementary Data Note 1: Summary of Significant Accounting Policies.

Revenue Recognition

Our revenues are derived from products and services delivered to our customers across our two businesses, Search & Directory and Mobile. In general, we recognize revenues in the period in which the services are performed, products are delivered or transaction occurs. In certain arrangements, we record deferred revenue for amounts received from customers in advance of the performance of services or upon execution of an agreement and recognize revenues ratably over the term of the agreement or expected customer life. We generally record revenue on a gross basis in accordance with Emerging Issues Task Force Issue 99-19 (EITF 99-19), *Reporting Revenue Gross as a Principal versus Net as an Agent*. For distribution partner arrangements in our Search & Directory business we record revenue on a gross basis and the corresponding revenue sharing payments as a content and distribution expense. For mobile operator customers in which we license the content, we record revenue on a gross basis and the corresponding licensing expense as content and distribution expense. In the event the mobile operator customer directly licenses the content, we record as revenue the service fees we earn. See Note 1 to our Consolidated Financial Statements for a description of products and services and the related revenue recognition policy for each of our business units.

Income Taxes

We account for income taxes under the asset and liability method, under which deferred tax assets, including net operating loss carryforwards, and liabilities are determined based on temporary differences between the book and tax basis of assets and liabilities. We periodically evaluate the likelihood of the realization of deferred tax assets, and reduce the carrying amount of the deferred tax assets by a valuation allowance to the extent we believe a portion will not be realized. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income, the carryforward periods available to us for tax reporting purposes, and other relevant factors. The range of possible judgments relating to the valuation of our deferred tax assets is wide.

At December 31, 2005, based on the weight of available evidence, we determined that it was more likely than not that a portion of our deferred tax asset would be realized and, at December 31, 2005, our deferred tax asset, net of the valuation allowance, is \$25.0 million. See discussion in our Results of Operations for the Years Ended December 31, 2005, 2004, and 2003. Significant judgment is required in making this assessment, and it is very difficult to predict when, if ever, our assessment may conclude that the remaining portion of our deferred tax assets is realizable.

Business Combinations

Business combinations accounted for under the purchase method of accounting require management to estimate the fair value of the assets and liabilities acquired. The allocation of the purchase price based on the estimated fair value of assets and liabilities acquired may be subject to

adjustments during the year following the date of acquisition.

Table of Contents

Allowances for Sales and Doubtful Accounts

Our management must make estimates of potential future sales allowances related to current period revenues for our products and services. We analyze historical adjustments, current economic trends and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales allowances. Estimates must be made and used in connection with establishing the sales allowance in any accounting period.

The allowance for doubtful accounts is a management estimate that considers actual facts and circumstances of individual customers and other debtors, such as financial condition and historical payment trends. We evaluate the adequacy of the allowance utilizing a combination of specific identification of potentially problematic accounts and identification of accounts that have exceeded payment terms.

Accounting for Goodwill and Certain Other Intangible Assets

Statement of Financial Accounting Standard (SFAS) No. 142, *Goodwill and Other Intangible Assets*, requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis and between annual tests in certain circumstances. Application of the 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 other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for each reporting unit. As of December 31, 2005 we have \$177.0 million of goodwill and \$44.1 million of other intangible assets on our balance sheet.

Stock-Based Compensation

Through December 31, 2005, we accounted for stock-based compensation under the intrinsic method in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. Under the intrinsic method, we did not record any expenses as stock options granted were priced at the fair market value of our stock at the date of grant.

On December 14, 2005, we accelerated vesting of certain unvested and out-of-the-money stock options with exercise prices equal to or greater than \$34.00 per share that were previously awarded under our equity compensation plans to our employees. These options were accelerated to avoid recording future compensation expense with respect to such options. We believe that because such options had exercise prices in excess of the current market value of our stock, the options were not achieving their original objective. The acceleration of vesting was effective for stock options outstanding as of December 14, 2005. Options to purchase 2.4 million shares of common stock were subject to the acceleration and the weighted average exercise price of the options subject to the acceleration was \$40.51. Due to this acceleration, an additional \$29.3 million is included in the pro forma stock-based compensation expense for the year ended December 31, 2005.

Commencing January 1, 2006, we will adopt SFAS No. 123(R), *Stock-Based Compensation*, which requires us to record stock compensation expense for equity based awards granted, including stock options, for which expense will be recognized over the service period of the equity based award based on the fair value of the award at the date of grant. The actual effects of adopting SFAS No. 123(R) will be dependent on numerous factors including, but not limited to, the valuation model chosen by us to value stock-based awards; the assumed award forfeiture rate; the accounting policies adopted concerning the method of recognizing the fair value of awards over the requisite service period; and the

Edgar Filing: INFOSPACE INC - Form 10-K

transition method chosen for adopting SFAS No. 123(R). See the [Recent Accounting Pronouncements](#) section below for further information.

Contingencies

We are subject to various legal proceedings and claims and tax matters, the outcomes of which are subject to significant uncertainty. SFAS No. 5, *Accounting for Contingencies*, requires that an estimated loss from a loss

Table of Contents

contingency should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial position or our results of operations. See Note 8 to our Consolidated Financial Statements for further information regarding contingencies.

Historical Results of Operations

For the year ending December 31, 2005, our net income totaled \$159.4 million, which includes a gain, net of related expenses, of \$79.3 million related to the settlement of several litigation matters and a \$25.0 million benefit from the realization of a deferred tax asset related to a portion of the net operating loss carryforward. While we have achieved profitability during our last ten quarters, prior to that we incurred losses since our inception and, as of December 31, 2005, had an accumulated deficit of \$1.0 billion.

In light of the rapidly evolving nature of our business and overall market conditions, we believe that period-to-period comparisons of our revenues and operating results are not necessarily meaningful, and you should not necessarily rely solely upon them as indications of future performance.

The following table sets forth the historical results of our operations (in thousands and as percent of revenues).

	Years Ended December 31,			Years Ended December 31,		
	2005	2004	2003	2005	2004	2003
	(in thousands)			(as a percent of revenue)		
Revenues	\$ 339,968	\$ 249,354	\$ 132,230	100.0%	100.0%	100.0%
Operating expenses						
Content and distribution	145,351	92,688	27,583	42.7	37.1	20.9
Systems and network operations	21,375	14,220	10,988	6.3	5.7	8.3
Product development	31,203	23,142	17,781	9.2	9.3	13.4
Sales and marketing	31,062	23,486	17,487	9.1	9.4	13.2
General and administrative	40,234	36,348	32,225	11.8	14.6	24.4
Depreciation	9,061	6,974	10,819	2.7	2.8	8.2
Amortization of intangible assets	15,265	9,920	6,819	4.5	4.0	5.1
Impairment of other intangible assets			1,151			0.9
Restructuring charges		222	11,722		0.1	8.9
Other, net		(3,203)	1,529		(1.3)	1.1
Total operating expenses	293,551	203,797	138,104	86.3	81.7	104.4
Operating income (loss)	46,417	45,557	(5,874)	13.7	18.3	(4.4)
Gain (loss) on investments	154	425	(11,997)	0.0	0.1	(9.1)
Other income, net	89,322	4,991	8,190	26.3	2.0	6.2
Income (loss) from continuing operations before income taxes	135,893	50,973	(9,681)	40.0	20.4	(7.3)
Income tax benefit	23,475	29	607	6.9	0.1	0.4
Income (loss) from continuing operations	159,368	51,002	(9,074)	46.9	20.5	(6.9)

Edgar Filing: INFOSPACE INC - Form 10-K

Income from discontinued operations, net of taxes		2,277	2,755		0.9	2.1
Gain on sale of discontinued operations, net of taxes		29,122			11.6	
Net income (loss)	\$ 159,368	\$ 82,401	\$ (6,319)	46.9%	33.0%	(4.8)%

Table of Contents**Results of Operations for the Years Ended December 31, 2005, 2004 and 2003**

Revenues. Revenues are derived from deploying our Internet software, services and products to customers. Under many of our agreements, we earn revenues from a combination of our products and services delivered to customers. In 2003, we sold or otherwise divested all of our non-core services. Revenues for the years ended December 31, 2005, 2004 and 2003 are presented below (in thousands):

	Percentage		Change		Percentage		Change		Percentage
	2005	of Total	from 2004	2004	of Total	from 2003	2003	of Total	
Mobile	\$ 157,412	46.3%	\$ 64,897	\$ 92,515	37.1%	\$ 64,586	\$ 27,929	21.1%	
Search & Directory	182,556	53.7	25,717	156,839	62.9	62,946	93,893	71.0	
Non-core services		0.0			0.0	(10,408)	10,408	7.9	
Total	\$ 339,968	100.0%	\$ 90,614	\$ 249,354	100.0%	\$ 117,124	\$ 132,230	100.0%	

Mobile Revenue

The absolute dollar increase in Mobile revenue from 2004 to 2005 is primarily due to an increase in sales of our media download products, including our labeltones or MP3-like quality ringtones and, to a lesser extent, graphics and games.

The absolute dollar increase in Mobile revenue from 2003 to 2004 is primarily due to an increase in the sales of our mobile media download products as a result of an acquisition of a media download business in November 2003. During 2003, we generated revenue primarily from our content delivery services, hosting and maintenance services, professional services and other infrastructure services to mobile operators.

We expect that media download revenues, in particular, sales of labeltones or MP3-like quality ringtones, will continue to be a greater share of our Mobile revenues.

Search & Directory Revenue

The absolute dollar increase in Search & Directory revenue from 2004 to 2005 is primarily due to growth in our paid search services from both our search and directory businesses, in particular, paid searches from our distribution partners Web properties and greater revenue per paid search, and directory revenues related to our acquisition of an online directory business in June 2004. In 2005, search revenues in North America from distribution partners remained at over 60% of total search revenues.

The absolute dollar increase in Search & Directory revenue from 2003 to 2004 is primarily due to growth in our paid search services from both our search and directory businesses, in particular, paid searches from our distribution partners Web properties and greater revenue per paid search, and directory revenues related to our acquisition of an online directory business in June 2004. In 2004, search revenues from distribution

Edgar Filing: INFOSPACE INC - Form 10-K

partners increased to over 60% of our search revenues in North America compared to less than 35% in 2003.

We expect that search revenue from our distribution partners will continue to be a greater share of our search revenues.

Revenue from non-core services

In 2003, as part of narrowing our focus, we sold or otherwise disposed of services falling outside of our core businesses.

Additional Revenue Information

There was no related party revenue or warrant revenue for the years ended December 31, 2005 and 2004. Related party revenue for the year ended December 31, 2003 was \$190,000, which included warrant revenue of \$134,000.

Table of Contents

Content and Distribution Expenses. Content and distribution expenses consist principally of costs related to royalty and license fees related to our mobile media download products for items such as ringtones, graphics and games, revenue sharing arrangements with our distribution partners in connection with our Search & Directory business and other content or data licenses. Content and distribution expenses in total dollars (in thousands) and as a percent of revenue for the years ended December 31, 2005, 2004 and 2003 are presented below:

	2005	Change	2004	Change	2003
Content and Distribution Expenses	\$ 145,351	\$ 52,663	\$ 92,688	\$ 65,105	\$ 27,583
Percent of Revenue	42.7%	5.6%	37.1%	16.2%	20.9%

Content and distribution expenses increased by \$52.7 million to \$145.4 million (or 42.7% of revenues) in 2005 as compared to \$92.7 million (or 37.1% of revenues) in 2004. The absolute dollar and percent of revenue increase was attributable to the growth from sales of our content and media download products to our mobile customers, including our higher cost labeltones or MP3-like quality ringtones, which require licensing and royalty payments to third parties and, to a lesser extent, revenue growth from our online search and directory distribution partners in which we have revenue sharing arrangements where we private label our search products for our partners to offer on their own Web properties.

Content and distribution expenses increased by \$65.1 million to \$92.7 million (or 37.1% of revenues) in 2004 as compared to \$27.6 million (or 20.9% of revenues) in 2003. The absolute dollar and percent of revenue increase was attributable to revenue growth from our online search and directory distribution partners in which we have revenue sharing arrangements where we private label our search products for our partners to offer on their own Web properties and the growth from sales of our content and media download products to our mobile customers, which require licensing and royalty payments to third parties.

We anticipate that our content and distribution expenses will continue to increase in absolute dollars if revenues from sales of our content and media download products to our mobile customers and revenues from our online search and directory distribution partners continue to increase. Content and distribution expenses as a percent of revenues may increase at a greater rate due to the shift in the mix of products and services provided. For example, in 2005, sales of labeltones or MP3-like quality ringtones, for which our costs as a percentage of revenue are greater than our other media download products, represented a larger share of our mobile revenues in 2005.

Systems and Network Operations Expenses. Systems and network operations consist of expenses associated with the delivery, maintenance and support of our products, services and infrastructure, including personnel expenses, which include salaries, benefits and other employee related costs, and temporary help and contractors to augment our staffing, communication costs and equipment repair and maintenance. Systems and network operations expenses in total dollars (in thousands) and as a percent of revenue for the years ended December 31, 2005, 2004 and 2003 are presented below:

	2005	Change	2004	Change	2003
Systems and Network Operations Expenses	\$ 21,375	\$ 7,155	\$ 14,220	\$ 3,232	\$ 10,988
Percent of Revenue	6.3%	0.6%	5.7%	(2.6)%	8.3%

Systems and network operations expenses increased by \$7.2 million to \$21.4 million (or 6.3% of revenues) for the year ended December 31, 2005 as compared to \$14.2 million (or 5.7% of revenues) for the year ended December 31, 2004. The increase in absolute dollars was primarily attributable to an increase of \$6.0 million in personnel expenses, including employee salaries and benefits and temporary help and contractors to augment our staffing, which was the result of additional headcount due to the growth in our business and also related to our acquisitions of an online directory business and three mobile gaming companies. Additionally, there was an increase of over \$1.0 million in facilities, software and equipment expenses to support the additional headcount and the operation of our new East Coast data center. Partially offsetting these increases was a decrease in communications costs of \$514,000 related to the renegotiation of certain contracts.

Table of Contents

Systems and network operations expenses increased by \$3.2 million to \$14.2 million (or 5.7% of revenues) for the year ended December 31, 2004 as compared to \$11.0 million (or 8.3% of revenues) for the year ended December 31, 2003. The increase in absolute dollars was primarily attributable to an increase of \$4.0 million in personnel expenses, including employee salaries and benefits and temporary help and contractors to augment our staffing, which was the result of additional headcount due to the growth in our business and also related to our acquisitions. Partially offsetting these increases was a decrease in communications costs of \$1.1 million.

Product Development Expenses. Product development expenses consist principally of personnel costs, which include salaries, benefits and other employee related costs, and temporary help and contractors to augment our staffing, research, development, support and ongoing enhancements of our products and services. Product development expenses in total dollars (in thousands) and as a percent of revenue for the years ended December 31, 2005, 2004 and 2003 are presented below:

	2005	Change	2004	Change	2003
Product Development Expenses	\$ 31,203	\$ 8,061	\$ 23,142	\$ 5,361	\$ 17,781
Percent of Revenue	9.2%	(0.1)%	9.3%	(4.1)%	13.4%

Product development expenses increased by \$8.1 million to \$31.2 million (or 9.2% of revenues) in 2005 as compared to \$23.1 million (or 9.3% of revenues) in 2004. The increase in absolute dollars was primarily due to an increase of \$7.5 million in personnel expenses, including employee salaries and benefits and temporary help and contractors to augment our staffing, as we continued to invest in the development and enhancement of our products and services and also as a result of additional headcount related to our acquisitions of an online directory business and three mobile gaming companies.

Product development expenses increased by \$5.4 million to \$23.1 million (or 9.3% of revenues) in 2004 as compared to \$17.8 million (or 13.4% of revenues) in 2003. The increase in absolute dollars was primarily due to an increase of \$4.7 million in personnel expenses, including employee salaries and benefits and temporary help and contractors to augment our staffing, as we continued to invest in the development and enhancement of our products and services and also as a result of additional headcount related to our acquisitions.

Product development costs may not be consistent with changes in revenues as they represent key costs to develop and enhance our product and service offerings. We believe that investments in technology are necessary to remain competitive, and we anticipate that product development expenses will increase as we continue to invest in our products and services.

Sales and Marketing Expenses. Sales and marketing expenses consist principally of personnel costs, which include salaries, benefits and other employee related costs, and temporary help and contractors to augment our staffing, advertising, market research and promotion expenses. Sales and marketing expenses in total dollars (in thousands) and as a percent of revenue for the years ended December 31, 2005, 2004 and 2003 are presented below:

	2005	Change	2004	Change	2003
Sales and Marketing Expenses	\$ 31,062	\$ 7,576	\$ 23,486	\$ 5,999	\$ 17,487
Percent of Revenue	9.1%	(0.3)%	9.4%	(3.8)%	13.2%

Sales and marketing expenses increased by \$7.6 million to \$31.1 million (or 9.1% of revenues) in 2005 as compared to \$23.5 million (or 9.4% of revenues) in 2004. The increase in absolute dollars was primarily attributable to an increase of \$4.1 million in advertising and promotion expense and an increase of \$3.4 million in personnel expenses, including salaries and benefits and temporary help and contractors to augment

Edgar Filing: INFOSPACE INC - Form 10-K

our staffing, as we continue to grow our business, and also as a result of our acquisitions of an online directory business and three mobile gaming companies.

Table of Contents

Sales and marketing expenses increased by \$6.0 million to \$23.5 million (or 9.4% of revenues) in 2004 as compared to \$17.5 million (or 13.2% of revenues) in 2003. The increase in absolute dollars was primarily attributable to an increase of \$3.0 million in personnel expenses, including salaries and benefits and temporary help and contractors to augment our staffing, as we continue to grow our business, and also as a result of our acquisitions, and an increase of \$2.7 million in advertising and promotion expense.

Sales and marketing expenses will increase in absolute dollars as we continue to invest in marketing initiatives, sales promotions, and new distribution channels, including a mobile direct to consumer channel, in our efforts to expand sales of our products and services.

General and Administrative Expenses. General and administrative expenses consist primarily of personnel expenses, which include salaries, benefits and other employee related costs, professional service fees, which include legal fees, audit fees, SEC compliance costs and costs related to compliance with the Sarbanes-Oxley Act of 2002, occupancy and general office expenses, and general business development and management expenses. General and administrative expenses in total dollars (in thousands) and as a percent of revenue for the years ended December 31, 2005, 2004 and 2003 are presented below:

	2005	Change	2004	Change	2003
General and Administrative Expenses	\$ 40,234	\$ 3,886	\$ 36,348	\$ 4,123	\$ 32,225
Percent of Revenue	11.8%	(2.8)%	14.6%	(9.8)%	24.4%

General and administrative expenses increased by \$3.9 million to \$40.2 million (or 11.8% of revenues) in 2005 as compared to \$36.3 million (or 14.6% of revenues) in 2004. The increase in absolute dollars was primarily attributable to an increase in facilities costs of \$2.4 million to expand facilities and build our East Coast data center in Waltham, Massachusetts, an increase of \$1.2 million in personnel costs and temporary help and contractors, to augment our staffing, as a result of our acquisitions of Switchboard and three gaming companies, and growth in operations, and an increase of \$1.4 million in professional services fees, which include tax and consulting fees. Partially offsetting these increases were reductions in legal fees of \$1.9 million and insurance costs of \$929,000.

General and administrative expenses increased by \$4.1 million to \$36.3 million (or 14.6% of revenues) in 2004 as compared to \$32.2 million (or 24.4% of revenues) in 2003. The increase in absolute dollars was primarily attributable to an increase of \$5.5 million in personnel costs and temporary help and contractors, to augment our staffing, as a result of our acquisitions, the hiring of a new senior management team, which was completed in the latter part of 2003, and increased costs related to our compliance with the Sarbanes-Oxley Act of 2002. A \$1.4 million increase in our bad debt expense was due to a combination of bad debt expense of \$328,000 in 2004 and a net bad debt recovery recorded in 2003 of \$1.0 million. Partially offsetting these increases were decreases in occupancy costs of \$1.8 million as a result of restructurings, renegotiations or expiration of certain contracts, and a reduction in insurance costs of \$1.1 million.

Depreciation. Depreciation of property and equipment includes depreciation of network servers and data center equipment, computers, software, office equipment and fixtures, and leasehold improvements. Depreciation expenses for the years ended December 31, 2005, 2004 and 2003 are presented below (in thousands):

	2005	Change	2004	Change	2003
Depreciation Expenses	\$ 9,061	\$ 2,087	\$ 6,974	\$ (3,845)	\$ 10,819

The \$2.1 million increase from 2004 to 2005 is primarily a result of property and equipment recently placed in service related to our East Coast data center and those acquired with our acquisitions of an online directory business and the three mobile gaming companies, partially offset by a

Edgar Filing: INFOSPACE INC - Form 10-K

decrease in depreciation expenses of older property and equipment reaching the end of their depreciable lives. The \$3.8 million decrease from 2003 to 2004 is primarily attributable to certain of our property and equipment reaching the end of its depreciable life.

Table of Contents

Amortization of Other Intangible Assets. Amortization of definite-lived intangible assets includes amortization of core technology, customer and content relationships, customer lists and other intangible assets. Definite-lived intangible assets are amortized over their estimated life, ranging from one to five years. Amortization of other intangible assets is presented below for the years ended December 31, 2005, 2004 and 2003 (in thousands):

	2005	Change	2004	Change	2003
Amortization of Other Intangible Assets	\$ 15,265	\$ 5,345	\$ 9,920	\$ 3,101	\$ 6,819

The \$5.3 million absolute dollar increase from 2004 to 2005 is primarily attributable to intangible assets that were acquired in the acquisitions of an online directory business and the three mobile gaming companies.

The \$3.1 million absolute dollar increase from 2003 to 2004 is attributable to the intangible assets that were acquired in our various business acquisitions in 2004 and 2003. The increase in amortization expense related to these acquisitions was partially offset by a reduction of intangible assets that were either impaired or fully amortized during 2004 and 2003.

Assuming we do not acquire businesses or intangible assets in the future, the amortization of intangible assets will be \$13.2 million in 2006, \$7.5 million in 2007, \$4.7 million in 2008 and \$3.1 million in 2009.

Impairment of Other Intangible Assets. During 2003, we determined that we would not pursue products related to a certain technology we acquired in a business acquisition and recorded an impairment charge of \$1.2 million for the remaining carrying value. We recorded no other intangible asset impairment charges for 2004 or 2005.

Restructuring Charges. We did not record any restructuring charges in 2005. Restructuring charges reflect actual and estimated costs associated with the reductions in workforce and costs associated with the consolidation and closures of certain of our facilities. Restructuring charges for the years ended December 31, 2005, 2004 and 2003 are presented below (in thousands):

	2005	2004	2003
Restructuring charges:			
Severance and related costs	\$	\$ (22)	\$ 4,543
Estimated future lease losses		(935)	4,723
Leasehold improvements and other asset disposal costs			1,903
Lease termination penalties		1,179	405
Realized fluctuation of foreign currency			148
	\$	\$ 222	\$ 11,722

The restructuring charge in 2004 is attributable to an adjustment of our estimated reserves for the restructuring in 2003, discussed below, primarily related to the payment of lease termination costs in lieu of subleasing our excess facilities. In 2003, we narrowed our strategic focus, which included the restructuring of our business units and the identification of certain non-core services to divest, and implemented operational restructuring plans to reduce operating costs, which included workforce reductions and consolidation of corporate facilities. In 2003, we recorded a charge of \$11.7 million comprised of employee severance and other separation charges, a charge for excess facilities, the write down

Edgar Filing: INFOSPACE INC - Form 10-K

of leasehold improvements and equipment related to the excess facilities and a charge for terminating a lease. The estimated future excess facilities cost was based on discounting the present value of future committed lease payments. Additionally, as part of our decision to close our operations in Australia, we recorded a charge of \$148,000 relating to the realized loss on foreign currency fluctuations. This amount was previously included in accumulated other comprehensive income on our consolidated balance sheet.

Table of Contents

Other, Net. Other, net consists of costs, charges, refunds or gains that are not directly associated with other revenue or operating expense classifications. Other, net for the years ended December 31, 2005, 2004 and 2003 is presented below (in thousands):

	2005	2004	2003
Other, net:			
Litigation settlement	\$	\$ (3,906)	\$ 7,549
Tax settlement			3,963
Tax refunds and credits		(266)	(3,192)
Gain on sale of non-core services			(6,376)
Executive severance and stock-based compensation		1,225	
Miscellaneous		(256)	(415)
	\$	\$ (3,203)	\$ 1,529

During 2004, we recorded other charges, net for a gain of \$3.2 million. We settled a litigation matter concerning promissory notes due from a former officer, resulting in a gain of \$3.9 million. Pursuant to the settlement agreement, we received \$3.3 million in cash and 18,438 shares of our common stock with a fair value of \$622,000 from the former officer in full settlement of promissory notes previously recorded for \$10.0 million and related interest earned of \$1.6 million on the promissory notes. We previously recorded a valuation allowance related to the promissory notes and related interest of \$11.6 million. Additionally, we recorded a charge of \$1.2 million related to the separation of a former executive officer, and we received a final assessment from the Internal Revenue Service (the IRS) for a payroll tax settlement regarding certain aspects of our payroll tax returns for the year 2000, in which we had previously recorded a \$4.0 million charge in 2003 that included penalties and estimated interest, and, accordingly, paid the IRS. The interest charges were less than originally estimated and, as a result, we reversed previously recognized interest charges of \$266,000 upon our payment of the final assessment.

During 2003, we recorded other charges, net of \$1.5 million, primarily comprised of a \$7.5 million charge for litigation and other settlement related to our Mobile business and a charge, which included estimated interest and penalties, related to a settlement agreement with the IRS regarding the audit of our payroll tax returns for the year 2000 in the amount of \$4.0 million. Partially offsetting these charges were research and development tax refunds or credits from local and foreign tax jurisdictions and gains on the sale or disposition of our non-core services, all of which were divested as of December 31, 2003.

Gain (Loss) on Equity Investments. Gain (loss) on equity investments consists of gains from changes in the fair value of derivative instruments held by us, recognized losses on investments, realized gains on equity investments and impairment of equity investments. Gain (loss) on equity investments is comprised of the following for the years ended December 31, 2005, 2004 and 2003 (in thousands):

	2005	2004	2003
Other-than-temporary investment impairments	\$	\$ (916)	\$ (12,281)
Loss on sale of investments			(398)
Increase in fair value of warrants	154	1,341	682
	\$ 154	\$ 425	\$ (11,997)

Other-than-temporary investment impairment: We have equity investments in public and privately held companies and periodically evaluate whether the decline in fair value of an investment is other-than-temporary. During 2004 and 2003, we concluded that there had been an other-than-temporary impairment of certain equity investments and we recorded an impairment charge related to those specific investments.

Losses on sale of investments: During 2004 and 2003, we sold the majority of our equity investments in public and privately-held companies as opportunities arose.

Table of Contents

Gains in fair value of warrants: In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, we adjust our derivative instruments to fair value and recognize the change in the recorded fair value in earnings. We hold warrants to purchase stock in other companies, which qualify as derivatives, and therefore gains or losses are based on the fair value. In 2004, a company in which we held warrants to purchase shares of stock announced that it was being acquired and that any outstanding warrants to purchase shares of the company would also be purchased. We recognized a gain and proceeds of \$1.4 million in 2004 based on the estimated fair value of the warrant. The warrant was subsequently purchased for \$1.5 million and we received the final payment and recorded a gain of \$154,000 in 2005.

Other Income, Net. Other income, net, primarily consists of interest income, litigation settlements and foreign currency gain (loss).

	2005	2004	2003
Interest income	\$ 11,250	\$ 4,698	\$ 4,191
Gain on litigation settlement	79,297		4,112
Foreign currency exchange gain (loss)	(1,131)	540	37
Other items, net	(94)	(247)	(150)
	\$ 89,322	\$ 4,991	\$ 8,190

Interest income more than doubled primarily due to increased interest rates in 2005 compared to 2004. In 2005, we received proceeds of \$83.2 million from the settlement of several outstanding litigation matters. We recognized a gain of \$79.3 million comprised of the settlement proceeds and interest, less \$3.9 million in legal fees.

In 2005, we acquired elkware GmbH, a mobile gaming company, at a cost of 20.0 million euros in cash. The purchase price in U.S dollars was \$26.4 million plus acquisition costs. In December 2004, due to the significant fluctuations in the exchange rate of the U.S. dollar to the euro, we entered into a forward exchange contract to mitigate our foreign currency exposure. At December 31, 2004, the exchange rate of the U.S. dollar had declined relative to the euro and a \$456,000 gain on the forward exchange contract was recorded in 2004. Subsequently, in January 2005 when the acquisition was consummated, the U.S. dollar had strengthened against the euro and a \$934,000 loss as a result of the settlement of that foreign exchange contract was recorded in 2005.

In 2003, we recognized a gain of \$4.1 million related to the settlement of a litigation matter.

Income Tax Benefit. During the years ended December 31, 2005, 2004 and 2003 we have recorded an income tax benefit from continuing operations of \$23.5 million, \$29,000 and \$607,000, respectively. The 2005 income tax benefit of \$23.5 million is primarily due a \$25.0 million benefit from the realization of a deferred tax asset related to a portion of the net operating loss carryforward, partially offset by tax expense for federal alternative minimum, state and international taxes, as more fully discussed below. The income tax benefit in 2003 was primarily related to the allocation of income tax expense to our discontinued operations of \$1.5 million.

At December 31, 2005, our net deferred tax asset is \$25.0 million and is based on total deferred tax assets of \$425.8 million, primarily comprised of \$379.7 million of accumulated net operating loss carryforwards, net of a \$400.8 million valuation allowance. Through September 30, 2005, we had provided a full valuation allowance on our deferred tax assets due to our history of operating losses. At the end of the year, we determined it was more likely than not that a portion of the operating loss carryforwards would be realizable in the foreseeable future. Accordingly, we reduced the valuation allowance related to our operating loss deferred tax assets and recognized a \$25.0 million deferred tax benefit in 2005. As of December 31, 2005, we continue to have a \$400.8 million valuation allowance against our deferred tax assets

principally related to net operating loss carryforwards. Due to

Table of Contents

the size of our net operating loss carryforwards, their expiration beginning in 2020, and our recent level of annualized profitability, we believe that significant uncertainty exists regarding the realizability of the remaining balance of our deferred tax assets. If in the future we determine that the remaining deferred tax assets are more likely than not to be realized, we would recognize a benefit of up to approximately \$35 million, subject to utilization of such benefit during the year, in the income statement. The remainder would be treated as a reduction of goodwill or credited to stockholders' equity on our consolidated balance sheet since they primarily relate to our acquisitions and stock-based tax deductions in excess of amounts recognized in our income statement for financial reporting purposes.

To the extent we are profitable and we record a tax expense, the actual payment may be offset against the accumulated net operating loss carryforwards. In 2006, we expect to record tax expense for U.S. federal, state, and alternative minimum taxes, which will be partially offset by a deferred tax benefit related to our foreign subsidiaries.

Income from Discontinued Operations and Gain on Sale of Discontinued Operation. On March 31, 2004, we consummated the sale of our Payment Solutions business and have reflected income from Payment Solutions as income from discontinued operations. For 2004, we recorded a gain on the sale of Payment Solutions of \$29.1 million, which was comprised of proceeds from the sale of \$82.0 million less the net book value of assets sold of \$49.3 million (including goodwill of \$48.9 million), and transaction related costs of \$3.6 million, which consist of investment banking fees, legal fees and employee related costs.

We have presented the operating results of Payment Solutions as a discontinued operation for all periods presented. We recorded income, net of taxes, from the operating results of Payment Solutions of \$2.3 million and \$2.8 million for the years ended December 31, 2004 and 2003, respectively. Income from discontinued operations includes previously unallocated depreciation, amortization, corporate expenses, and income taxes that were attributed to Payment Solutions.

Balance Sheet Commentary

Payroll Taxes. As of December 31, 2004, we had a \$13.2 million payroll tax receivable. The receivable was comprised of income tax withholdings of \$12.6 million and \$620,000 in payroll taxes related to the exercise of non-qualified stock options in 2000 by Anuradha Jain, one of our former officers and the spouse of Naveen Jain, our former chairman and chief executive officer (collectively referred to as the Jains). On April 15, 2005, we collected \$12.2 million from the Jains. In the third quarter of 2005, we collected the remainder of the receivable balance, net of an unrelated tax liability of \$197,000 that was included in Accrued expenses and other current liabilities at December 31, 2004.

Liquidity and Capital Resources

Our principal source of liquidity is our cash and cash equivalents, short-term investments and long-term investments, initially generated from proceeds from stock sales of approximately \$614 million, which include private placements and our initial and follow-on public offerings. In addition, more recently we have generated cash from operations. In 2005, we received proceeds of \$83.2 million from the settlement of certain litigation matters and, in 2004, we received proceeds of \$82.0 million from the sale of our Payment Solutions business unit.

As of December 31, 2005, we had cash and marketable investments of \$375.4 million, consisting of cash and cash equivalents of \$153.0 million and short-term investments available-for-sale of \$222.4 million. At December 31, 2005, we have no long-term investments. We invest our excess cash in high quality marketable investments. These investments include securities issued by U.S. government agencies, certificates of

deposit, money market funds, and taxable municipal bonds.

Table of Contents*Commitments and Pledged Funds*

The following are our contractual commitments associated with our operating lease obligations (in thousands):

	2006	2007	2008	2009	2010	Thereafter	Total
Minimum lease payments required	\$ 5,854	\$ 5,521	\$ 3,760	\$ 5,339	\$ 5,393	\$ 9,869	\$ 35,736
Less sublease income	(163)						(163)
Net lease payments required	\$ 5,691	\$ 5,521	\$ 3,760	\$ 5,339	\$ 5,393	\$ 9,869	\$ 35,573

We have no significant purchase commitments at December 31, 2005. We have pledged a portion of our cash as collateral for standby letters of credit and bank guaranties for certain of our property leases and banking arrangements. At December 31, 2005, the total amount of collateral pledged under these agreements was \$4.0 million.

Cash Flows

Net cash provided by operating activities consists of net income (loss) offset by certain adjustments not affecting current-period cash flows and the effect of changes in our operating assets and liabilities. Adjustments to net income (loss) to determine cash flow from operations include depreciation and amortization, impairment of intangible assets, gains or losses on equity investments, warrant and stock-based related revenues and expenses, gains and losses from the disposition of non-core services and other assets, certain restructuring charges, deferred taxes and the cumulative effect of changes in accounting principles. Net cash used by investing activities consists of net cash used to acquire businesses, transactions related to our investments, purchases of property and equipment and proceeds from the sale of certain assets. Net cash provided (used) by financing activities consists of proceeds from the issuance of stock through the exercise of stock options or warrants and our employee stock purchase plan and cash used to repurchase outstanding stock.

Our net cash flows are comprised of the following for the years ended December 31, 2005, 2004 and 2003 (in thousands):

	Year Ended December 31,		
	2005	2004	2003
Net cash provided by operating activities	\$ 157,587	\$ 51,109	\$ 46,408
Net cash used by investing activities	(33,552)	(109,519)	(25,931)
Net cash provided (used) by financing activities	(56,267)	32,747	3,616
Net increase (decrease) in cash and cash equivalents	\$ 67,768	\$ (25,663)	\$ 24,093

Net cash provided by operating activities was \$157.6 million in 2005, consisting of our net income of \$159.4 million, cash provided by changes in our operating assets and liabilities of \$25.0 million, consisting of a decrease in notes and other receivables, an increase in accrued expenses and accounts payable, and adjustments not affecting cash flows provided by operating activities of \$24.9 million, primarily consisting of depreciation and amortization and bad debt expense. Partially offsetting the increase are changes in our operating assets and liabilities of \$24.7 million, primarily consisting of increases in our accounts receivable, prepaid expenses and other current assets and other long-term assets and a

Edgar Filing: INFOSPACE INC - Form 10-K

decrease in our deferred revenue, and adjustments not affecting cash flows provided by operating activities of \$27.1 million, primarily consisting of the benefit from the reversal of the deferred tax asset valuation allowance and a gain from our equity investments.

Net cash provided by operating activities was \$51.1 million in 2004, consisting of our net income of \$82.4 million, cash provided by changes in our operating assets and liabilities of \$17.6 million, consisting of an

Table of Contents

increase in our accrued expenses, deferred revenues and a decrease in prepaid expenses and adjustments not affecting cash flows provided by operating activities of \$18.4 million, primarily consisting of depreciation and amortization, stock-based compensation and bad debt expense, and non-cash restructuring charges. Partially offsetting the increase are cash used by changes in our operating assets and liabilities of \$35.0 million, primarily consisting of increases in our accounts receivable, notes and other receivables, other long-term assets and a decrease in our accounts payable, and adjustments not affecting cash flows provided by operating activities of \$32.3 million, primarily consisting of income and the gain on sale of our Payment Solutions business of \$31.4 million, accounted for as a discontinued operation, and gains from our equity investments.

Net cash provided by operating activities was \$46.4 million in 2003, consisting of our net loss of \$6.3 million, cash provided by changes in our operating assets and liabilities of \$34.2 million, primarily consisting of increases in accrued expenses and other current and long-term liabilities, changes in net assets of discontinued operations, increases in notes and other receivables and accounts receivable, and adjustments not affecting cash flows provided by operating activities of \$33.8 million, primarily consisting of depreciation and amortization, losses on equity investments, and restructuring and impairment charges. Partially offsetting the increase are cash used by changes in our operating assets and liabilities of \$5.0 million, primarily consisting of increases in our prepaid expenses and other assets, and a decrease in our deferred revenue, and adjustments not affecting cash flows provided by operating activities of \$10.3 million, primarily consisting of gains from the sale of our non-core services, bad debt recoveries and income from our discontinued operation.

Net cash used by investing activities was \$33.6 million in 2005, primarily from the purchase of \$189.0 million of marketable investments, the use of \$26.4 million for business acquisitions, net of cash acquired, increase of long-term assets of \$4.5 million and \$17.0 million of property and equipment purchases. Partially offsetting cash used in investing activities were proceeds from the sale or maturity of our marketable investments of \$202.9 million, proceeds of \$139,000 from the sale of assets and proceeds of \$154,000 upon the final settlement of warrants sold in 2004.

Net cash used by investing activities was \$109.5 million in 2004, primarily from the purchase of \$499.2 million of marketable investments, the use of \$130.6 million for business acquisitions, net of cash acquired, and \$10.4 million of property and equipment purchases. Partially offsetting cash used in investing activities were proceeds from the sale or maturity of our marketable investments of \$446.4 million, proceeds of \$82.0 million from the sale of our Payment Solutions business, and proceeds of \$2.3 million from the sale of equity investments and our non-core services.

Net cash used by investing activities was \$25.9 million in 2003, primarily from the proceeds of \$263.5 million from the sale or maturity of our marketable investments and proceeds of \$18.1 million from the sale of equity investments and non-core services and assets. Partially offsetting cash provided by investing activities were the purchase of \$276.2 million of marketable investments, the use of \$29.1 million for business acquisitions, net of cash acquired, and purchases of property and equipment of \$2.2 million.

Net cash used by financing activities in 2005 was \$56.3 million, primarily from the repurchase of 2.6 million shares of common stock for \$70.4 million, including commissions. Partially offsetting cash used in financing activities were proceeds of \$14.1 million from the exercise of stock options and from the sale of shares through our employee stock purchase plan. Net cash provided by financing activities in 2004 and 2003 was \$32.7 million and \$3.6 million, respectively. Cash proceeds from financing activities resulted from the exercise of stock options and from the sale of shares through our employee stock purchase plan.

We plan to use our cash to fund operations, develop technology, advertise, market and distribute our products and services, and continue the enhancement of infrastructure including the completion of our East Coast data center in Waltham. We may use our cash to repurchase outstanding shares or for acquisitions, examples being our 2004 acquisition of an online directory business and the acquisition of three mobile gaming companies in 2004 and early 2005.

Table of Contents

We believe that existing cash balances, cash equivalents, short term investments and cash generated from operations will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. However, the underlying assumed levels of revenues and expenses may not prove to be accurate. Our anticipated cash needs exclude any payments for pending or future litigation matters. In addition, we evaluate acquisitions of businesses, products or technologies that complement our business from time to time. Any such transactions, if consummated, may use a significant portion of our cash balances and marketable investments. We may seek additional funding through public or private financings or other arrangements prior to such time. Adequate funds may not be available when needed or may not be available on favorable terms. If we raise additional funds by issuing equity securities, dilution to existing stockholders will result. If funding is insufficient at any time in the future, we may be unable to develop or enhance our products or services, take advantage of business opportunities or respond to competitive pressures, any of which could harm our business.

Market Sensitive Derivatives and Financial Instruments

On December 15, 2004, we entered into a definitive agreement to acquire the outstanding stock of elkware GmbH, a German mobile games company. The purchase price was denominated in euros in the amount of 20.0 million euros. Due to significant changes in the exchange rate and the continued devaluation of the U.S. dollar to the euro, on December 22, 2004 we entered into a forward exchange contract to minimize any further exposure of the U.S. dollar weakening relative to the euro, which locked the exchange rate at 1.3416 for each dollar per euro. The acquisition was completed on January 7, 2005 and the forward contract was settled.

Acquisitions**Summary of Our Acquisitions**

Company or Assets	Date Closed	Total Value of Transaction (in thousands)
elkware GmbH	01/07/2005	\$ 26,400
IOMO Limited	12/01/2004	15,400
Atlas Mobile, Inc.	07/01/2004	6,300
Switchboard Incorporated	06/03/2004	159,400
Moviso LLC	11/26/2003	25,000
Saraide, Inc. (remaining interest)	11/26/2003 and 12/31/03	1,100
Contactpage.com, Inc	10/21/2003	2,600

elkware GmbH. On January 7, 2005, we acquired elkware GmbH, a German mobile games company, for 20.0 million euros, which approximated \$26.4 million in cash, excluding acquisition costs and liabilities assumed. In addition, the purchase agreement required that 5.0 million euros of the purchase price be placed in escrow to provide security for certain indemnification obligations set forth in the purchase agreement.

IOMO Limited. In December 2004, we acquired the outstanding stock of IOMO Limited, a designer and publisher of mobile games, for 8.0 million British pounds, which approximated \$15.4 million in cash, excluding acquisition costs and liabilities assumed. In addition, the

Edgar Filing: INFOSPACE INC - Form 10-K

purchase agreement required that 1.1 million British pounds of the purchase price be placed in escrow to provide security for certain indemnification obligations set forth in the purchase agreement.

Atlas Mobile, Inc. In July 2004, we acquired the assets of Atlas Mobile, a provider of mobile multi-player tournament games, for \$6.3 million.

Table of Contents

Switchboard Incorporated. In June 2004, we acquired the outstanding stock of Switchboard Incorporated, a provider of local online advertising and Internet based yellow pages, for \$159.4 million in cash, which excludes transaction fees of \$6.0 million and liabilities assumed. As of the acquisition date, Switchboard had \$56.4 million in cash.

Moviso LLC. In November 2003, we acquired the membership interests of Moviso LLC, a North American mobile media content provider for \$25.0 million in cash, excluding acquisition costs and liabilities assumed.

Saraide, Inc. In March 2000, we acquired 80% of the common stock of Saraide, Inc., a component of our Mobile business. In 2003, we acquired the remaining 20% interest in Saraide, Inc. at an aggregate cost of \$8.6 million, which includes the cost of a settlement with certain shareholders of Saraide, Inc. of \$7.5 million.

Contactpage.com, Inc. In October 2003, we acquired substantially all of the technology and intellectual property of Contactpage.com, Inc. for \$2.6 million in cash.

Table of Contents**Quarterly Results of Operations (Unaudited)**

The following table presents a summary of our unaudited consolidated results of operations for the eight quarters ended December 31, 2005. The information for each of these quarters has been prepared on a basis consistent with our audited consolidated financial statements. You should read this information in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K. The operating results for any quarter are not necessarily indicative of results for any future period.

	March 31,	June 30,	September 30,	December 31,	March 31,	June 30,	September 30,	December 31,
	2004	2004	2004	2004	2005	2005	2005	2005
	(in thousands except per share data)							
Revenues	\$ 48,081	\$ 54,448	\$ 67,151	\$ 79,674	\$ 87,022	\$ 83,181	\$ 83,225	\$ 86,540
Operating expenses:								
Content and distribution	16,886	18,611	24,537	32,654	34,830	34,864	37,704	37,953
Systems and network operations	3,218	3,813	3,498	3,691	4,413	4,899	5,492	6,571
Product development	4,438	5,580	6,436	6,688	7,371	7,596	7,840	8,396
Sales and marketing	5,458	5,083	6,212	6,733	7,872	7,030	8,519	7,641
General and administrative	9,494	8,998	9,565	8,291	10,605	9,729	9,671	10,229
Depreciation	1,799	1,745	1,681	1,749	1,774	1,941	2,454	2,892
Amortization of intangible assets	1,741	2,002	3,061	3,116	4,083	3,763	3,709	3,710
Restructuring charges	(49)	271						
Other, net	1,090	(3,922)	(246)	(125)				
Total operating expenses	44,075	42,181	54,744	62,797	70,948	69,822	75,389	77,392
Operating income	4,006	12,267	12,407	16,877	16,074	13,359	7,836	9,148
Gain (loss) on investments	458		(33)			154		
Other income, net	985	1,176	1,000	1,830	80,154	2,838	2,974	3,356
Income from continuing operations before income taxes	5,449	13,443	13,374	18,707	96,228	16,351	10,810	12,504
Income tax benefit (expense)	(32)	(71)	(18)	150	(2,329)	(65)	451	25,418
Income from continuing operations	5,417	13,372	13,356	18,857	93,899	16,286	11,261	37,922
Discontinued operations:								
Income from discontinued operations, net of taxes	2,277							
Gain on sale of discontinued operations, net of taxes	28,989	133						
Net income	\$ 36,683	\$ 13,505	\$ 13,356	\$ 18,857	\$ 93,899	\$ 16,286	\$ 11,261	\$ 37,922
Earnings per share Basic								
Income from continuing operations	\$ 0.17	\$ 0.42	\$ 0.42	\$ 0.58	\$ 2.84	\$ 0.49	\$ 0.35	\$ 1.22
Income from discontinued operations	\$ 0.99	\$	\$	\$	\$	\$	\$	\$
Net income per share	\$ 1.16	\$ 0.42	\$ 0.42	\$ 0.58	\$ 2.84	\$ 0.49	\$ 0.35	\$ 1.22
Weighted average shares outstanding used in computing basic net income per share	31,568	31,915	32,183	32,766	33,054	33,108	31,958	31,042
Earnings per share Diluted								
Income from continuing operations	\$ 0.15	\$ 0.37	\$ 0.37	\$ 0.50	\$ 2.52	\$ 0.44	\$ 0.32	\$ 1.13
Income from discontinued operations	\$ 0.88	\$	\$	\$	\$	\$	\$	\$

Edgar Filing: INFOSPACE INC - Form 10-K

Net income per share	\$ 1.03	\$ 0.37	\$ 0.37	\$ 0.50	\$ 2.52	\$ 0.44	\$ 0.32	\$ 1.13
Weighted average shares outstanding used in computing diluted net income per share	35,654	36,245	36,411	37,850	37,327	36,720	34,830	33,612

Table of Contents

	March 31, 2004	June 30, 2004	September 30, 2004	December 31, 2004	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Operating expenses:								
Content and distribution	35.1	34.2	36.5	41.0	40.0	41.9	45.3	43.9
Systems and network operations	6.7	7.0	5.2	4.6	5.1	5.9	6.6	7.6
Product development	9.2	10.3	9.6	8.4	8.5	9.1	9.4	9.7
Sales and marketing	11.4	9.3	9.3	8.5	9.0	8.5	10.2	8.8
General and administrative	19.8	16.5	14.2	10.4	12.2	11.7	11.6	11.8
Depreciation	3.7	3.2	2.5	2.2	2.0	2.3	3.0	3.3
Amortization of intangible assets	3.6	3.7	4.6	3.9	4.7	4.5	4.5	4.3
Restructuring charges	(0.1)	0.5						
Other, net	2.3	(7.2)	(0.4)	(0.2)				
Total operating expenses	91.7	77.5	81.5	78.8	81.5	83.9	90.6	89.4
Operating income	8.3	22.5	18.5	21.2	18.5	16.1	9.4	10.6
Gain (loss) on investments	1.0					0.2		
Other income, net	2.0	2.2	1.4	2.3	92.1	3.4	3.6	3.8
Income from continuing operations before income taxes	11.3	24.7	19.9	23.5	110.6	19.7	13.0	14.4
Income tax benefit (expense)		(0.1)		0.2	(2.7)	(0.1)	0.5	29.4
Income from continuing operations	11.3	24.6	19.9	23.7	107.9	19.6	13.5	43.8
Discontinued Operations:								
Income from discontinued operations, net of taxes	4.7							
Gain on sale of discontinued operations, net of taxes	60.3	0.2						
Net income	76.3%	24.8%	19.9%	23.7%	107.9%	19.6%	13.5%	43.8%

Recent Accounting Pronouncements

As of December 31, 2005, we account for stock-based compensation awards using the intrinsic value measurement provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Accordingly, we record no compensation expense for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the date of grant. On December 16, 2004, the Financial Accounting Standards Board (the FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)) and in March 2005, the SEC issued Staff Accounting Bulletin No. 107, *Share-Based Payment* (SAB No. 107) relating to the adoption of SFAS No. 123(R). SFAS No. 123(R) eliminates the alternative of applying the intrinsic value measurement provisions of APB Opinion No. 25 to stock compensation awards. Rather, SFAS No. 123(R) requires enterprises to measure the cost of services received in exchange for an award of equity

Edgar Filing: INFOSPACE INC - Form 10-K

instruments based on the fair value of the award at the date of grant.

We will adopt SFAS No. 123(R) effective January 1, 2006, using the Modified Prospective Application Method. Under this method SFAS No. 123(R) is applied to new awards and to awards modified, repurchased, or cancelled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (such as unvested options) that are outstanding as of the date of adoption shall be recognized as the remaining requisite services are rendered. The compensation cost relating to unvested awards at the date of adoption shall be based on the fair value at the date of grant of those awards as calculated for pro forma disclosures under the original SFAS No. 123.

We expect that the adoption of SFAS No. 123(R) will impact our financial results in the future, as it is expected to significantly reduce our net income as we have not had significant stock-based compensation expense in the recent past. As of December 31, 2005, we have unamortized stock-based compensation expense of \$16.8 million, of which, \$9.3 million is expected to be expensed in 2006. However, this amount does not reflect

Table of Contents

the expense associated with equity awards that are expected to be granted to employees in 2006. Management is currently reviewing its alternatives for granting equity based awards and, while we expect to continue granting equity based awards to our employees, the type and amount of award is still under consideration. Accordingly, the overall effect of adopting this new standard on the financial results for 2006 has not yet been quantified. The pro forma effects on net income and earnings per share if we had applied the fair value recognition provisions of original SFAS No. 123 on stock compensation awards (rather than applying the intrinsic value measurement provisions of APB Opinion No. 25) are disclosed in Item 8 of Part II Financial Statements and Supplementary Data Note 1: Stock-based compensation. Although such pro forma effects of applying the original SFAS No. 123 may be indicative of the effects of adopting SFAS No. 123(R), the provisions of these two statements differ in important respects. The actual effects of adopting SFAS No. 123(R) will be dependent on numerous factors including, but not limited to, the valuation model chosen by us to value stock-based awards; the assumed award forfeiture rate; the accounting policies adopted concerning the method of recognizing the fair value of awards over the requisite service period; and the transition method chosen for adopting SFAS No. 123(R).

In March 2005, the FASB issued Interpretation (FIN) 47, *Accounting for Conditional Asset Retirement Obligations*. This clarifies the term conditional asset retirement obligation as used in SFAS No. 143, *Accounting for Asset Retirement Obligations*, and provides guidance to ensure consistency in recording legal obligations associated with long-lived tangible asset retirements. We do not believe adoption of FIN 47 will have a material effect on our financial position, cash flows or results of operations.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, a replacement of Accounting Principles Board Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements* (SFAS No. 154). SFAS No. 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, voluntary changes in accounting principles were generally required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements. We do not believe adoption of SFAS No. 154 will have a material effect on our financial position, cash flows or results of operations.

In November 2005, the FASB issued Staff Position No. FAS 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, (FSP No. 115-1). FSP No. 115-1 provides accounting guidance for identifying and recognizing other-than-temporary impairments of debt and equity securities, as well as cost method investments in addition to disclosure requirements. FSP No. 115-1 is effective for reporting periods beginning after December 15, 2005, and earlier application is permitted. This new pronouncement will be effective in 2006 and we do not believe that adoption of FSP No. 115-1 will have a material effect on our financial position, cash flows or results of operations.

Table of Contents**ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to financial market risks, including changes in interest rates and equity price fluctuations.

Interest Rate Risk. We invest our available cash in investment-grade debt instruments of corporate issuers and in debt instruments of the U.S. Government and its agencies. By policy, we limit our credit exposure to any one issuer. We do not have any derivative instruments in our investment portfolio. We protect and preserve invested funds by limiting default, market and reinvestment risk. Investments in both fixed-rate and floating-rate interest earning instruments 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, while floating-rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if we are forced to sell securities which have declined in market value due to changes in interest rates. At December 31, 2005, our short-term investment balances were \$222.4 million.

The following table provides information about our cash equivalent and marketable fixed-income securities, including principal cash flows for 2005 and the related weighted average interest rates. Amounts are presented in U.S. dollar equivalents, which is our reporting currency.

Principal amounts by expected year of maturity in U.S. dollars as of December 31, 2005 are as follows (in thousands, except percentages):

	2006	Fair Value
Corporate bonds	\$ 21,060	\$ 21,008
Weighted average interest rate	2.99%	
U.S. government securities	100,787	100,367
Weighted average interest rate	3.19%	
Auction Rate securities	100,985	100,985
Weighted average interest rate	4.41%	
Commercial Paper	119,146	119,170
Weighted average interest rate	4.86%	
Cash equivalents and marketable fixed-income securities	\$ 341,978	\$ 341,530

Foreign Currency Risk: Our earnings and cash flows are subject to fluctuations due to changes in the exchange rates of the principal currency of countries that we operate in (Canada and countries in Europe) versus the U.S. dollar. We are exposed to these exchange rate fluctuations as the financial results of our non-U.S. based subsidiaries are translated into U.S. dollars in consolidation. As exchange rates vary, those results, when translated, may vary from expectations and adversely impact our results. The cumulative translation effects for subsidiaries using functional currencies other than the U.S. dollar are included in accumulated other comprehensive income in stockholders' equity. We do not currently use derivative instruments to manage our exposure to changes in foreign currency exchange rates as this exposure has had an immaterial impact on our past financial results.

Table of Contents

ITEM 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

INFOSPACE, Inc.	Page
<u>Report of Independent Registered Public Accounting Firm</u>	49
<u>Consolidated Balance Sheets</u>	50
<u>Consolidated Statements of Operations and Comprehensive Income (Loss)</u>	51
<u>Consolidated Statements of Changes in Stockholders' Equity</u>	52
<u>Consolidated Statements of Cash Flows</u>	53
<u>Notes to Consolidated Financial Statements</u>	54

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

InfoSpace, Inc.

Bellevue, Washington

We have audited the accompanying consolidated balance sheets of InfoSpace, Inc. and subsidiaries (the Company) as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive income (loss), changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of InfoSpace, Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the PCAOB, the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 23, 2006 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

DELOITTE & TOUCHE LLP

Seattle, Washington

February 23, 2006

Table of Contents**INFOSPACE, INC.****CONSOLIDATED BALANCE SHEETS**

(amounts in thousands, except share data)

	December 31,	
	2005	2004
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 153,013	\$ 85,245
Short-term investments, available-for-sale	222,360	198,410
Accounts receivable, net of allowance of \$1,507 and \$929.	71,661	57,110
Notes and other receivables, net of allowance of \$0 and \$93	3,972	7,259
Payroll tax receivable		13,214
Prepaid expenses and other current assets	12,639	3,623
Total current assets	463,645	364,861
Long-term investments, available-for-sale		38,159
Property and equipment, net	26,889	16,782
Goodwill	176,979	158,810
Other intangible assets, net	44,080	46,189
Deferred tax asset, net	25,000	
Other long-term assets	6,786	1,293
Total assets	\$ 743,379	\$ 626,094
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Current liabilities:		
Accounts payable	\$ 11,585	\$ 6,669
Accrued expenses and other current liabilities	51,917	44,031
Short-term deferred revenue	2,474	4,750
Total current liabilities	65,976	55,450
Long-term liabilities:		
Long-term deferred revenue	2,011	503
Deferred tax liability	10,421	7,745
Total long-term liabilities	12,432	8,248
Total liabilities	78,408	63,698
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, par value \$.0001 authorized, 15,000,000 shares; issued and outstanding, 0 and 2 shares		
Common stock, par value \$.0001 authorized, 900,000,000 shares; issued and outstanding, 31,018,795 and 32,894,177 shares	3	3
Additional paid-in capital	1,684,974	1,741,241
Accumulated deficit	(1,020,525)	(1,179,893)
Accumulated other comprehensive income	519	1,045
Total stockholders' equity	664,971	562,396

Edgar Filing: INFOSPACE INC - Form 10-K

Total liabilities and stockholders' equity	\$ 743,379	\$ 626,094
--	------------	------------

See notes to consolidated financial statements.

Table of Contents**INFOSPACE, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)**

(amounts in thousands, except per share data)

	Years Ended December 31,		
	2005	2004	2003
Revenues	\$ 339,968	\$ 249,354	\$ 132,230
Operating expenses:			
Content and distribution	145,351	92,688	27,583
Systems and network operations	21,375	14,220	10,988
Product development	31,203	23,142	17,781
Sales and marketing	31,062	23,486	17,487
General and administrative	40,234	36,348	32,225
Depreciation	9,061	6,974	10,819
Amortization of other intangible assets	15,265	9,920	6,819
Impairment of other intangible assets			1,151
Restructuring charges		222	11,722
Other, net		(3,203)	1,529
Total operating expenses	293,551	203,797	138,104
Operating income (loss)	46,417	45,557	(5,874)
Gain (loss) on investments, net	154	425	(11,997)
Other income, net	89,322	4,991	8,190
Income (loss) from continuing operations before income tax benefit	135,893	50,973	(9,681)
Income tax benefit	23,475	29	607
Income (loss) from continuing operations	159,368	51,002	(9,074)
Discontinued operations:			
Income from discontinued operations, net of taxes		2,277	2,755
Gain on sale of discontinued operations, net of taxes		29,122	
Net income (loss)	\$ 159,368	\$ 82,401	\$ (6,319)
Earnings (loss) per share Basic:			
Income (loss) from continuing operations	\$ 4.94	\$ 1.59	\$ (0.29)
Income from discontinued operations	\$	\$ 0.98	\$ 0.09
Basic net income (loss) per share	\$ 4.94	\$ 2.57	\$ (0.20)
Weighted average shares outstanding used in computing basic net income (loss) per share	32,284	32,109	31,232
Earnings (loss) per share Diluted:			
Income (loss) from continuing operations	\$ 4.47	\$ 1.40	\$ (0.29)
Income from discontinued operations	\$	\$ 0.86	\$ 0.09
Diluted net income (loss) per share	\$ 4.47	\$ 2.26	