

MARCHEX INC  
Form 10-K  
March 12, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-K**

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

For the fiscal year ended December 31, 2012

or

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

For the transition period from            to            .

Commission File Number 000-50658

**Marchex, Inc.**

(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of

35-2194038  
(I.R.S Employer

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incorporation or organization) Identification No.)  
520 Pike Street, Suite 2000, Seattle, Washington 98101

(Address of principal executive offices, including zip code)

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

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

| Title of Each Class   | Name of Exchange on Which Registered |
|-----------------------|--------------------------------------|
| Class B Common Stock, | The NASDAQ Stock Market LLC          |

|                            |                               |
|----------------------------|-------------------------------|
| \$0.01 par value per share | (NASDAQ Global Select Market) |
|----------------------------|-------------------------------|

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

None

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

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

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

|  |   |
|--|---|
| Large accelerated filer <input type="checkbox"/>   | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company <input type="checkbox"/>    |

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

Aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was approximately \$83,183,526 as of June 30, 2012 based upon the closing sale price on the NASDAQ Global Select Market reported for such date. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

There were 9,570,382 shares of the registrant's Class A common stock issued and outstanding as of March 8, 2013 and 28,185,224 shares of the registrant's Class B common stock issued and outstanding as of March 8, 2013.

**DOCUMENTS INCORPORATED BY REFERENCE**

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Portions of the registrant's definitive proxy statement for the 2013 Annual Meeting of Stockholders are incorporated herein by reference in Part III of this Annual Report on Form 10-K to the extent stated herein.

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**FORWARD-LOOKING STATEMENTS**

*This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use words such as believes, intends, expects, anticipates, plans, may, will and similar expressions to identify forward-looking statements. All forward-looking statements, including, but not limited to, statements regarding our future operating results, financial position, prospects, acquisitions and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are inherently uncertain as they are based on our expectations and assumptions concerning future events. In addition, there are certain risks and uncertainties relating to our proposed separation transaction which contemplates a separation of our mobile and call advertising business and our domain and advertising marketplace business, including, but not limited to, the impact and possible disruption to our operations, the timing and certainty of completing the transaction, the high costs in connection with the spin-off which we would not be able to recoup if the spin-off is not consummated, the expectation that the spin-off will be tax-free, revenue and growth expectations for the two independent companies following the spin-off, unanticipated developments that may delay or negatively impact the spin-off, and the ability of each business to operate as an independent entity upon completion of the spin-off. Any or all of our forward-looking statements in this report may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including the risks, uncertainties and assumptions described in Item 1A of this Annual Report on Form 10-K under the caption Risk Factors and elsewhere in this report. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements. All forward-looking statements in this report are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.*

**PART 1**

**ITEM 1. BUSINESS.**

**Overview**

References herein to we, us or our refer to Marchex, Inc. and its wholly-owned subsidiaries unless the context specifically states or implies otherwise.

Marchex is a mobile performance advertising company that delivers customer calls to businesses and analyzes those calls so companies can get the most out of their advertising. Marchex is a leading mobile and online advertising company that drives millions of consumers to connect with businesses over the phone, delivers quality phone calls, and provides in-depth analysis of those phone calls.

Through our robust platform, we offer three critical components for businesses looking to acquire new customers through phone calls. Marchex Call Analytics offers ad campaign measurement and intelligence, and our Digital Call Marketplace and Local Leads solutions are designed for advertisers focused on new customer acquisition. The Marchex platform drives, measures and monetizes millions of mobile and online connections through the phone to advertisers each month.

We offer products, services and technologies that enable advertisers of all sizes to reach consumers across mobile, online and offline sources. Our products and services primarily include: digital call-based advertising, pay-per-click advertising, and our proprietary web site traffic sources. In addition, we provide performance marketing solutions, including private-label products for small businesses, to a network of large reseller partners

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including Yellow Pages publishers, media, telecommunications companies and vertical marketing service providers (i.e. companies that sell advertising products to large numbers of small advertisers). Marchex enables these partners to sell digital call marketing and analytics, search advertising products and analytics and/or presence management products to their end customers, which are then created, managed and fulfilled through our distribution networks including our proprietary web site traffic sources.

We generate revenue from two primary sources: our performance-based digital call advertising and our non-call driven sources including pay-per-click listings on our proprietary web site traffic sources. During the years ended December 31, 2010, 2011 and 2012, revenue from our proprietary web site traffic sources accounted for approximately 27%, 14%, and 8% of total revenues, respectively. We operate primarily in domestic markets. For detail on revenue by geographical area for the three most recent fiscal years, see Note 13 Segment Reporting and Geographic Information of the notes to our consolidated financial statements.

Marchex was incorporated in Delaware on January 17, 2003.

## **Proposed Separation**

On November 1, 2012, Marchex announced that its board of directors has authorized Marchex to pursue the separation of its business into two distinct publicly traded entities. The separation is expected to be a tax-free pro rata distribution in which Marchex's existing stockholders would hold interests in: (1) Marchex, a mobile advertising company focused on calls, and (2) Archeo, a domain and click-based advertising business. Completion of the proposed separation is subject to certain conditions, including final approval by Marchex's board of directors, receipt of regulatory approvals, favorable tax rulings and/or opinions regarding the tax-free nature of the transaction to Marchex and to its stockholders, further due diligence as appropriate, and the filing and effectiveness of appropriate filings with the Securities and Exchange Commission. While Marchex expects to complete the separation during 2013, we cannot assure that the separation will be completed, and if completed, on the anticipated timeline or that the terms of the separation will not change. Following the separation, Marchex will cease to own any equity interest in Archeo, and Archeo will operate as an independent, publicly-traded company. See Item 1A. Risk Factors for certain risk factors relating to the proposed business separation.

## **Products and Services**

We are a mobile performance advertising company that delivers customer calls to businesses and analyzes those calls so companies can get the most out of their advertising. We deliver call and click-based advertising products and services to tens of thousands of advertisers, ranging from small businesses to Fortune 500 companies. Our technology-based products and services facilitate the efficient and cost-effective marketing and selling of goods and services for national advertisers and small businesses who want to market and sell their products through call-ready media including mobile, online and offline sources; and a proprietary, locally-focused web site network where we help consumers find local information, as well as fulfill our advertiser marketing campaigns. Our primary products are as follows:

**Digital Call Marketplace.** Through our Digital Call Marketplace, we deliver a variety of digital call advertising products and services to national advertisers, advertising agencies and small advertiser reseller partners. These services include providing targeted pay-for-call advertisements through the Marchex Digital Call Marketplace, and Marchex Call Analytics, one of the largest sources of call-ready media in North America. It offers exclusive and preferred ad placements across numerous mobile and online media sources, so advertisers can drive qualified calls to their businesses. It leverages our Call Analytics platform to secure call tracking numbers and to provide qualified calls to advertisers that block spam and other telemarketing calls while working to optimize the return on investment for advertisers' marketing investment.

**Call Analytics.** Our Call Analytics (technology platform) provides data and insights that measure the performance of mobile, online and offline advertising for advertisers and small business resellers. It includes phone numbers, call tracking, recording, call mining, real-time intelligence and several other

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insights to help advertisers make more informed campaign optimization decisions to drive quality customer calls from their advertising and measure their return on investment across all media channels. Advertisers pay us a fee for each call they receive from call-based ads we distribute through our sources of call distribution or for each phone number tracked based on a pre-negotiated rate.

**Local Leads.** Our Local Leads platform, is a white-labeled, full service digital advertising solution for small business resellers, such as Yellow Pages providers and vertical marketing service providers, to sell digital call advertising and/or search marketing and other lead products through their existing sales channels to their small business advertisers. These calls and leads are then fulfilled by us across our distribution network, including mobile sources, and leading search engines. By creating a solution for companies who have relationships with small businesses, it is easier for these small businesses to participate in mobile, online, and offline call advertising. The lead services we offer to small business advertisers through our Local Leads platform include products typically available only to national advertisers, including pay-for-call, call tracking, presence management ad creation, keyword selection, geo-targeting, advertising campaign management, reporting, and analytics. The Local Leads platform has the capacity to support hundreds of thousands of advertiser accounts. Reseller partners and publishers generally pay us account fees and agency fees for our products in the form of a percentage of the cost of every call or click delivered to their advertisers. Through our contract with Yellowpages.com LLC d/b/a AT&T Interactive which is a subsidiary of AT&T (collectively, AT&T ), Our arrangement with AT&T relates to a business unit that is included in a company formed by AT&T in 2012 called YP Holdings, LLC ( YP ) that AT&T sold a majority stake in to a private equity third party in 2012. YP is our largest reseller partner and was responsible for 27% of our total revenues for the year ended December 31, 2012, of which the majority is derived from our local leads platform.

**Pay-Per-Click Advertising.** We deliver pay-per-click advertisements to online users in response to their keyword search queries or on pages they visit throughout our distribution network of search engines, shopping engines, certain third party vertical and local web sites, mobile distribution and our own proprietary web site traffic sources. In addition to distributing their ads, we offer account management services to help our advertisers optimize their pay-per-click campaigns, including editorial and keyword selection recommendations and report analysis. The pay-per-click advertisements are generally ordered based on the amount our advertisers choose to pay for a placement and the relevancy of their ads to the keyword search. Advertisers pay us when a user clicks on their advertisements in our distribution network and we pay publishers or distribution partners a percentage of the revenue generated by the click-throughs on their site(s). In addition, we generate revenue from cost-per-action events that take place on our distribution network. Cost-per-action revenue occurs when the user is redirected from one of our web sites or a third party web site in our distribution network to an advertiser's web site and completes a specified action. We also offer a private-label platform for publishers, which enable them to monetize their web sites with contextual advertising from their own customers or from our advertising relationships. We sell pay-per-click contextual advertising placements on specialized vertical and branded publisher web sites on a pay-per-click basis. Advertisers can target the placements by category, site or on a page-specific basis. We believe our site- and page-specific approach provides publishers with an opportunity to generate revenue from their traffic while protecting their brand. Our approach gives advertisers greater transparency into the source of the traffic and relevancy for their ads and enables them to optimize the return on investment from their advertising campaigns. The contextual advertisement placements are generally ordered based on the amount our advertisers choose to pay for a placement and the relevance of the advertisement, based on historic click-through rates. Advertisers pay us when a user clicks on their advertisements in our network and we pay publishers a percentage of the revenue generated by the click-throughs on their site.

**Proprietary Web Site Traffic.** Our Proprietary Web Site Traffic includes more than 200,000 of our owned and operated web sites focused on helping users make informed decisions about where to get local products and services. The more than 200,000 web sites in our network include more than 75,000 U.S. ZIP code sites, including 98102.com and 90210.com, covering ZIP code areas nationwide, as well

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as tens of thousands of other locally-focused sites such as Yellow.com, OpenList.com and geo-targeted sites. Traffic to our proprietary web sites is primarily monetized with pay-per-click listings that are relevant to the web sites, as well as other forms of advertising, including impression-based advertising.

**Our Distribution Network**

We have built a broad distribution network for our pay-for-call and pay-per-click advertising services that includes our Proprietary Web Site Traffic Sources, which are comprised of our owned and operated web sites, and hundreds of other sources including mobile sources, search engines and applications, directories, third party vertical and branded web sites, and offline sources.

***Proprietary Web Site Traffic Sources:***

We believe our Proprietary Web Site Traffic is a source of local information online and is a source of click-throughs within the Archeo Advertising Marketplace. It includes more than 200,000 web sites focused on helping users make informed decisions about products and services, including where to get local products and services.

The more than 200,000 owned and operated web sites in the network include more than 75,000 U.S. ZIP code sites, including 98102.com and 90210.com, covering ZIP code areas nationwide, as well as tens of thousands of other locally-focused sites such as Yellow.com, OpenList.com and geo-targeted sites. Traffic to our proprietary web sites is primarily monetized with pay-per-click listings that are relevant to the web sites, as well as other forms of advertising, including impression-based advertising.

***Syndicated Distribution:***

Through our digital call advertising services, our local leads, pay-per-click advertising services, and search marketing services, we distribute advertisements from our tens of thousands of advertisers, as well as from our reseller partners advertisers, through hundreds of call-ready media and traffic sources, including mobile sources, search engines and directories, web sites and our proprietary web site traffic sources.

Our Syndicated Distribution partners include:

| <b>Selected Carriers</b> | <b>Selected Search Engines</b> | <b>Selected Call Sources and Vertical and Local Distribution Partners</b> |
|--------------------------|--------------------------------|---|
| AT&T                     | Google                         | Bankrate  |
| Verizon                  | Microsoft                      | BusinessWeek.com  |
| Sprint (Boost Mobile)    | Yahoo!                         | CBS/CNET  |
| Metro PCS                |                                | CityGrid  |
| TracFone                 |                                | Google Mobile   |
|                          |                                | Investopedia  |
|                          |                                | Whitepages, Inc.  |
|                          |                                | Yahoo!  |

Payment arrangements with our distribution partners are often subject to minimum payment amounts per phone call or click-through. Other payment structures that we may use to a lesser degree include:

advance or fixed payments, based on a guaranteed minimum amount of usage delivered;



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variable payments based on a specified metric, such as number of paid phone calls or click-throughs; and

a combination arrangement with both fixed and variable amounts.

### **Industry Overview**

Today, we are witnessing an evolution in consumer behavior as consumers are increasingly looking to the phone to research and reach out to businesses. According to Morgan Stanley's Mobile Internet Report, mobile Internet use is predicted to outstrip desktop use by 2014. This growth in mobile Internet use coupled with the

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growth of new emerging technologies, like voice-over-Internet protocols, are changing how the PC is used as a communication device, making it easy for consumers to reach businesses over the phone. As a result, in today's marketing environment it is critical for large and small businesses alike to adopt a variety of strategies to market to consumers wherever they are looking for goods and services.

As businesses have expanded their marketing through mobile and online channels to meet consumer behavior, they are increasingly turning to more measurable forms of advertising with performance-based characteristics, such as pay-for-call or pay-per-click advertising, where an advertiser is only charged when a call is completed or a consumer clicks on an ad. The shift to performance-based advertising models has been significant as it adds transparency and measurability to advertising spending. According to the Internet Advertising Bureau, between 1999 and the first half of 2012, when large advertisers began to embrace online advertising because of its performance-based characteristics, the performance-based pricing models, which includes pay-per-click and cost-per action, grew from 7% to 67% of online advertising while the total Internet advertising market was \$4.6 billion in 1999 and is projected to be over \$36 billion for the full year 2012.

Today, performance-based advertising products continue to grow in prominence as advertisers demand greater control, transparency and measurability from their marketing dollars. We believe that a similar shift to performance-based advertising products will be a growth driver in the mobile advertising market. According to the Gartner Group, mobile internet advertising in North America is expected to grow from approximately \$3 billion in 2012 to approximately \$9 billion in 2016. In addition, the growth in mobile platforms also highlights the growing demand for advertisers to connect with customers over the phone. In a 2011 study independently commissioned by Marchex and conducted by Forrester Consulting, Forrester found that 49% of advertisers view calls as the most desirable result of their marketing dollars. Now that the technology is in place to analyze numerous factors critical to delivering calls on a performance basis, including the ability to identify and extract spam calls before those calls reach advertisers, and identify and filter different types of callers across media, we believe we will see increased adoption from advertisers. Over time, we believe the convergence of technology, including mobile platforms, with the needs of advertisers for new and evolving performance advertising products like pay-for-call will warrant greater budget allocation from large and small businesses compared to less transparent and measurable forms of advertising.

### **Strategy**

To take advantage of the shift to performance-based models in marketing, key elements of our strategy include:

***Innovating on Our Digital Mobile Performance Advertising.*** We plan to continue to expand our range of call-based advertising product capabilities by offering innovative performance-based products like pay-for-call advertising, along with the supporting analytics including number provisioning, call tracking, call mining, keyword-level tracking and other products as part of our owned, end-to-end, call-based advertising solutions. We are also focused on growing our base of call distribution by bringing in new sources of the rapidly growing mobile advertising market as well as other online and offline sources of distribution.

***Innovating on Our Products for Small Businesses.*** We plan to build and integrate new products into our marketing products for small businesses, including, (1) launching new performance-based small business solutions like pay-for-call advertising; (2) integrating more options for small businesses to acquire more customers through the phone, including enhanced local ad-targeting capabilities that will enable us to consistently improve the matching of our small advertisers with our sources of call supply; (3) introducing products that enable small businesses to better cultivate relationships with existing customers; and (4) adding additional features and functionality to our web sites that connect consumers with small businesses and provide additional monetization capabilities. We believe these new products will increase our cross-sell opportunities, enable us to continue to grow our advertiser base, unlock more budget from our existing advertisers, enable us to attract new reseller partnerships and deliver better performance to our existing partners.

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***Growing the Number of Advertisers Using Our Products and Services.*** We believe we will continue to increase the number of advertisers using Marchex products and services and build advertiser loyalty by providing a consistently high level of service and support as well as the ability to achieve their return on investment goals. We will continue to grow our advertiser base through our direct sales and marketing efforts, including strategic sales, inside sales, online acquisition initiatives and additional partnerships with large local advertiser reseller partners.

***Developing New Markets.*** We intend to analyze opportunities and may seek to expand our technology-based products into new business areas or geographic markets where our services can be replicated on a cost-effective basis, or where the creation or development of a product or service may be appropriate. We anticipate utilizing various strategies to enter new markets, including: developing strategic relationships; acquiring products that address a new category or opportunity; and creating joint venture relationships and internal initiatives where existing services can be extended internationally.

***Pursuing Selective Acquisition Opportunities.*** We may pursue select acquisition opportunities and will apply rigorous evaluation criteria to any acquisitions we may pursue in order to enhance our strategic position, strengthen our financial profile, augment our points of defensibility and increase shareholder value. We will focus on acquisition opportunities that represent a combination of the following characteristics:

under-leveraged and under-commercialized assets;

opportunities for business model, product or service innovation and evolution;

critical mass of transactions volume, advertisers, traffic, revenue and profits;

business defensibility;

revenue growth and expanding margins and operating profitability or the characteristics to achieve significant scale and profitability; and

an opportunity to enhance efficiencies and provide incremental growth opportunities for our operating businesses.

### **Sales, Marketing & Business Development**

Our sales department focuses on adding new advertisers to our business, while our business development and partnership department focuses on adding new reseller partnerships, selectively adding new distribution partnerships and servicing existing partnerships. Our marketing department focuses on promoting our services through online customer acquisition, affiliate relationships, press coverage, strategic marketing campaigns and industry exposure. Advertising and promotion of our services is broken into four main categories: direct sales, reseller partnerships, online acquisition, and referral agreements.

***Direct Sales.*** Our direct sales team targets new relationships with national advertisers and advertising agencies through in-person presentations, direct marketing, telesales and attendance at industry events, among other methods. Our advertiser agreements include a combination of agency fees, per-call and per-click fees.

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**Reseller Partnerships.** We have a business development team that focuses primarily on securing partnerships with large local advertiser reseller partners under which we supply our private-label small business advertising platform and/or other services, including advertiser distribution in our proprietary web site traffic network or our distribution network. Our reseller partner agreements include a combination of revenue sharing, licensing revenue, per-call and per-click fees.

**Online Acquisition.** We market to advertisers for our proprietary web site traffic network, pay-per-click advertising and contextual advertising through certain online advertising and direct marketing campaigns that lead advertisers to our self-serve online sign up processes. Self-serve advertisers generally pay us per-click fees.

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***Referral Agreements.*** We have referral agreements with entities that promote our services to large numbers of potential advertisers.

Our referral partner agreements are based on a combination of revenue sharing and performance-based fees.

We intend to continue our strategy of growing our advertiser base through sales and marketing programs while being as efficient as possible in terms of our marketing and advertising costs. We continually evaluate our marketing and advertising strategies to maximize the effectiveness of our programs and their return on investment.

### **Information Technology and Systems**

We have a proprietary technology platform for the purposes of managing and delivering call and click-based advertising products and services to our partners. We also combine third party licenses and hardware to create an operating environment for delivering high quality products and services, with such features as automated online account creation and management process for advertisers, real-time customer support with both interactive and online reporting for customers and partners. We employ commercially available technologies and products distributed by various companies, including Cisco, Dell, Oracle, Intel, Microsoft, IBM, Nuance and Veritas. We also utilize public domain software such as Apache, Linux, MySQL, PostgreSQL, Java and Tomcat.

Our technology platform is compatible with the systems used by our distribution partners, enabling us to deliver call and click-based advertising products and services through mobile, online and offline sources in rapid response to user queries made through such partners at scale. We continue to build and innovate additional functionality to attempt to meet the quickly evolving demands of the marketplace. We devote significant financial and human resources to improving our advertiser and partner experiences by continuing to develop our technology infrastructure. The cost of developing our technology solutions is included in the overall cost structure of our services and is not separately funded by any individual advertisers or partners. In order to maintain a professional level of service and availability, we primarily rely upon third parties to provide hosting services, including hardware support and service, and network monitoring at various domestic and international locations. Our servers are configured for high availability and large volumes of call, mobile and Internet traffic and are located in leased third party facilities. Back-end databases make use of redundant servers and data storage arrays. We also have standby servers that provide for additional capacity as necessary. The facilities housing our servers provide redundant HVAC, power and internet connectivity. As revenue grows and the volume of transactions and call, mobile and internet traffic increases, we will need to expand our network infrastructure. Inefficiencies in our network infrastructure to scale and adapt to higher call, mobile and internet traffic volumes could materially and adversely affect our revenue and results of operations.

We continuously review ways to improve major aspects of our technology support and maintenance, including improving, upgrading and implementing business continuity plans, data retention initiatives, and backup and recovery processes.

### **Competition**

We currently or potentially compete with a variety of companies, including Google, IAC/InterActiveCorp, Microsoft, Yahoo! and ReachLocal. Our Archeo Domain Marketplace competitors include Demand Media, Name Media and Oversee.net. Many of our potential competitors, as well as potential entrants into our target markets, have longer operating histories, larger customer or user bases, greater brand recognition and greater financial, marketing and other resources than we have. Many current and potential competitors can devote substantially greater resources than we can to marketing, web site and systems development. In addition, as the use of the mobile, Internet, and other online services increases, there will likely be larger, more well-established and well-financed entities that acquire companies relevant to our business strategy; and invest in or form joint ventures in categories or countries relevant to our business strategy; all of which could adversely impact our business. Any of these trends could increase competition, reduce the demand for any of our services and could have a material adverse effect on our business, operating results and financial condition.

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We believe our strategy allows us to work with most, if not all, of the relevant companies in our industry, even those companies that may be perceived as our competitors. To some extent, we may compete with our business partners, as we do with all other types of advertising sales companies and agencies. We may also compete with traditional offline media such as television, radio and print and direct marketing companies, for a share of advertisers' total advertising budgets. Although our strategy enables us to work with most, if not all, of our competitors, there are no guarantees that all companies will view us as a potential partner.

We provide our services to and also may compete with: (1) mobile and online advertisers; (2) partners who provide a distribution network for mobile, online, and offline advertising; and (3) other intermediaries who may provide purchasing and/or sales opportunities, including advertising agencies, and other search engine marketing companies. Many of the companies that could fall into these categories are also our partners, including Google, Yahoo!, Citysearch, Microsoft and YP. We depend on maintaining and continually expanding our network of partners and advertisers to generate mobile and online transactions.

The mobile and online advertising and marketing services industry is highly competitive. In addition, we believe today's typical Internet and mobile advertiser is becoming more sophisticated in utilizing the different forms of Internet and mobile advertising, purchasing Internet and mobile advertising in a cost-effective manner, and measuring return on investment. The competition for this pool of advertising dollars has also put downward pressure on price points and mobile and online advertisers have demanded more effective means of reaching customers. We believe these factors have contributed to the growth in performance-based advertising relative to certain other forms of online advertising and marketing, and as a result this sector has attracted many competitors.

Due to the long-term growth trends in mobile and online advertising, these competitors, real and potential, range in size and focus. Our competitors may include such diverse participants as small referral companies, established advertising agencies, inventory resellers, search engines, and destination web sites. We are also affected by the competition among destination web sites that reach users or customers of search services. While thousands of smaller outlets are available to customers, several large media and search engine companies, such as Google, Yahoo!, Microsoft and IAC, dominate online user traffic. The online search industry continues to experience consolidation of major web sites and search engines, which has the effect of increasing the negotiating power of these parties in relation to smaller providers. The major destination web sites and distribution providers may have leverage to demand more favorable contract terms, such as pricing, renewal and termination provisions.

There are additional competitive factors relating to attracting and retaining users, including the quality and relevance of our search results, and the usefulness, accessibility, integration and personalization of the mobile and online services that we offer as well as the overall user experience on our web sites. The other features that we offer, which we believe attract advertisers are reach, effectiveness and creativity of marketing services, and tools and information to help track performance.

Finally, we operate in the relatively nascent market of call-based advertising which is an innovative and new market. The adoption of these call-based products could take longer than we expect and could become more competitive as the category becomes more developed and visible.

## **Seasonality**

We have and we believe we will experience seasonality with our business. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of mobile and Internet usage and seasonal purchasing cycles of many advertisers. Our experience has shown that during the spring and summer months, mobile and Internet usage is lower than during other times of the year and during the latter part of the fourth quarter of the calendar year we generally experience lower call volume and reduced demand for calls from our mobile call advertising customers. The extent to which usage and call volume may decrease during these

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off-peak periods is difficult to predict. Prolonged or severe decreases in usage and call volume during these periods may adversely affect our growth rate and results. Additionally, the current business environment has generally resulted in advertisers and reseller partners reducing advertising and marketing services budgets or changing such budgets throughout the year, which we expect will impact our quarterly results of operations in addition to the typical seasonality seen in our industry.

### **Intellectual Property and Proprietary Rights**

We seek to protect our intellectual property through existing laws and regulations and by contractual restrictions. We rely upon trademark, patent and copyright law, trade secret protection and confidentiality or license agreements with our employees, customers, partners and others to help us protect our intellectual property.

Our technologies involve a combination of proprietary rights, owned and developed by us, commercially available software and hardware elements that are licensed or purchased by us from various providers, including Cisco, Dell, Oracle, Intel, Microsoft, IBM and Veritas, and public domain software, such as Apache, Linux, MySQL, IBM Java and Tomcat. We continue to develop additional technologies to update, supplement and replace existing components of the platform. We intend to protect our proprietary rights through patent and additional intellectual property laws.

Our policy is to apply for patents or for other appropriate intellectual property protection when we develop valuable new or improved technology. We currently own the following pending patent applications and issued patents:

U.S. Patent Number 7,668,950 entitled Automatically Updating Performance-Based Online Advertising System and Method was issued February 23, 2010.

U.S. Nonprovisional Patent Application Number 11/985,188 entitled Method and System for Tracking Telephone Calls was filed on November 14, 2007 and a corresponding divisional Patent Application Number 13/294,436 was filed November 11, 2011.

U.S. Patent Number 6,822,663 entitled Transform Rule Generator for Web-Based Markup Languages was issued November 23, 2004.

U.S. Nonprovisional Patent Application Number 12/512,821 entitled Facility for Reconciliation of Business Records Using Genetic Algorithms was filed on July 30, 2009.

U.S. Nonprovisional Patent Application Number 12/829,372 entitled System and Method to Direct Telephone Calls to Advertisers and U.S. Nonprovisional Patent Application Number 12/829,373 entitled System and Method for Calling Advertised Telephone Numbers on a Computing Device and U.S. Patent Number 8,259,915 (issued September 4, 2012) entitled System and Method to Analyze Calls to Advertised Telephone Numbers were all filed on July 1, 2010. Respective corresponding PCT Application Numbers PCT/US11/42792, PCT/US11/42812 and PCT/US11/42819 were filed July 1, 2011.

U.S. Nonprovisional Patent Application Number 13/176,709 entitled Method and System for Automatically Generating Advertising Creatives was filed July 5, 2011.

U.S. Nonprovisional Patent Application Number 12/844,488 entitled Systems and Methods for Blocking Telephone Calls was filed on July 27, 2010 and corresponding PCT Application Number PCT/US11/45403 was filed July 26, 2011.

U.S. Patent Number 7,212,615 entitled Criteria Based Marketing For Telephone Directory Assistance was issued May 1, 2007 and owned by Jingle Networks, which we acquired in 2011.

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U.S. Patent Number 7,702,084 entitled Toll-Free Directory Assistance With Preferred Advertisement Listing was issued April 20, 2010.



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U.S. Patent Number 7,961,861 entitled Telephone Search Supported By Response Location Advertising was issued June 14, 2011 and corresponding European Application Number 5826299.99 was filed November 29, 2005.

U.S. Nonprovisional Patent Application Number 11/290,148 entitled Telephone Search Supported By Advertising Based On Past History Of Requests was filed November 29, 2005.

U.S. Nonprovisional Patent Application Number 11/291,094 entitled Telephone Search Supported By Keyword Map To Advertising was filed November 29, 2005.

U.S. Patent Number 8,175,231 entitled Toll-Free Directory Assistance With Automatic Selection Of An Advertisement From A Category issued May 8, 2012.

U.S. Patent Number 8,107,602 entitled Directory Assistance With Data Processing Station issued January 12, 2012.

U.S. Nonprovisional Patent Application Number 13/677,248 entitled System and Method to Customize a Connection Interface for Multimodal Connection to a Telephone Number was filed November 14, 2012.

The status of any patent involves complex legal and factual questions. The scope of allowable claims is often uncertain. As a result, we cannot be sure that: (1) any patent application filed by us will result in a patent being issued; (2) that any patents issued in the future will afford adequate protection against competitors with similar technology; and (3) that the patents issued to us, if any, will not be infringed upon or designed around by others. Furthermore, the performance-based search advertising industry has been the subject of numerous patents and patent applications, which in turn has resulted in litigation. The outcome of this ongoing litigation or any future claims in this sector may adversely affect our business or financial prospects.

We have registered trademarks in the United States for Adhere by Marchex, DPG, Form to Phone, Local Is The New Black, Marchex, Marchex and Design, Marchex Adhere, Marchex Adhere Logo, Marchex Voice Services, Openlist, Opportunity Doesn't Knock it Calls!, 1-800-Free411, 1-800-Free411 and Design, JingleConnect, Jingle Networks and SwitchPitch. We also own pending U.S. trademark applications for Archeo and Digital Properties. In addition, we have trademark registrations for Marchex in Australia, Brazil, Canada, China, the European Union, Hong Kong, India, Japan, Republic of Korea, Russian Federation and Taiwan.

We have also applied for registration of Marchex in a number of other foreign jurisdictions. We do not know whether we will be able to successfully defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights in Internet-related industries are uncertain and still evolving.

**Regulation**

The manner in which existing laws and regulations should be applied to the Internet and call-based advertising services in general, and how they relate to our businesses in particular, is unclear. A host of federal and state laws covering user privacy, defamation, pricing, advertising, taxation, gambling, sweepstakes, promotions, financial market regulation, quality of products and services, computer trespass, telemarketing, spyware, adware, child protection and intellectual property ownership and infringement are potentially applicable to our business practices and the content offered by our mobile and online distribution partners.

In addition, our business is impacted by laws in a constant state of flux, and new legislation is introduced on a regular basis. Any such new legislation could expose us to substantial liability, including significant expenses necessary to comply with such laws and regulations. Courts may apply each of these laws in unintended and unexpected ways. As a company that provides services over the Internet as well as call recording and call tracking services, we may be subject to an action brought under any of these or future laws.

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Several federal and state laws that could have an impact on our business practices and compliance costs have already been adopted:

The Digital Millennium Copyright Act (DMCA) provides protection from copyright liability for online service providers that list or link to third party web sites. We currently qualify for the safe harbor under the DMCA; however, if it were determined that we did not meet the safe harbor requirements, we could be exposed to copyright infringement litigation, which could be costly and time-consuming.

The Children's Online Privacy Protection Act (COPPA) restricts the online collection of personal information about children and the use of that information. The Federal Trade Commission (FTC) has the authority to impose fines and penalties upon web site operators and online service providers that do not comply with the law's requirements. We do not currently offer any web sites or online services directed to children, nor do we knowingly collect personal information from children.

The Protection of Children from Sexual Predators Act requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.

The Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act of 2003 establishes requirements for those who send commercial e-mails, spells out penalties for entities that transmit noncompliant commercial e-mail and/or whose products are advertised in noncompliant commercial e-mail and gives consumers the right to opt-out of receiving commercial e-mails. The majority of the states also have adopted similar statutes governing the transmission of commercial e-mail. The FTC and the states, as applicable, are authorized to enforce the CAN-SPAM Act and the state-specific statutes, respectively. CAN-SPAM gives the Department of Justice the authority to enforce its criminal sanctions. Other federal and state agencies can enforce the law against organizations under their jurisdiction, and companies that provide Internet access may sue violators as well.

The Electronic Communications Privacy Act prevents private entities from disclosing Internet subscriber records and the contents of electronic communications, subject to certain exceptions.

The Computer Fraud and Abuse Act and other federal and state laws protect computer users from unauthorized computer access/hacking, and other actions by third parties which may be viewed as a violation of privacy. Courts may apply each of these laws in unintended and unexpected ways. As a company that provides services over the Internet as well as call recording and call tracking services, we may be subject to an action brought under any of these or future laws.

Among the types of legislation currently being considered at the federal and state levels are consumer laws regulating for the use of certain types of software applications or downloads and the use of cookies. These proposed laws are intended to target specific types of software applications often referred to as spyware, invasiveware or adware, and may also cover certain applications currently used in the online advertising industry to serve and distribute advertisements. In addition, the FTC has sought inquiry regarding the implementation of a do-not-track requirement. Federal legislation is also expected to be introduced that would regulate online behavioral advertising practices. If passed, these laws would impose new obligations for companies that use such software applications or technologies.

The Communications Act of 1934, as amended by the Telecommunications Act of 1996 (the Act), and the regulations promulgated by the Federal Communications Commission under Title II of the Act, may impose federal licensing, reporting and other regulatory obligations on the Company. To the extent we contract with and use the networks of voice over IP service providers, new legislation or FCC regulation in this area could restrict our business, prevent us from offering service or increase our cost of doing business. There are an increasing number of regulations and rulings that specifically address access to commerce and communications services on the Internet, including IP telephony. We are unable to predict the impact, if any that future legislation, legal decisions or regulations concerning voice services offered via the Internet may have on our business, financial condition, and results of operations.

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The U.S. Congress, the FCC, state legislatures or state agencies may target, among other things, access or settlement charges, imposing taxes related to Internet communications, imposing tariffs or other

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regulations based on encryption concerns, or the characteristics and quality of products and services that we may offer. Any new laws or regulations concerning these or other areas of our business could restrict our growth or increase our cost of doing business.

The FCC has initiated a proceeding regarding the regulation of broadband services. The increasing growth of the broadband IP telephony market and popularity of broadband IP telephony products and services heighten the risk that the FCC or other legislative bodies will seek to regulate broadband IP telephony and the Internet. In addition, large, established telecommunication companies may devote substantial lobbying efforts to influence the regulation of the broadband IP telephony market, which may be contrary to our interests.

There is risk that a regulatory agency will require us to conform to rules that are unsuitable for IP communications technologies or rules that cannot be complied with due to the nature and efficiencies of IP routing, or are unnecessary or unreasonable in light of the manner in which we offer voice-related services such as call recording and pay-for-call services to our customers.

Federal and state telemarketing laws including the Telephone Consumer Protection Act, the Telemarketing Sales Rule, the Telemarketing Consumer Fraud and Abuse Prevention Act and the rules and regulations promulgated thereunder.

Laws affecting telephone call recording and data protection, such as consent and personal data statutes. Under the federal Wiretap Act, at least one party taking part in a call must be notified if the call is being recorded. Under this law, and most state laws, there is nothing illegal about one of the parties to a telephone call recording the conversation. However, several states (i.e., California, Connecticut, Florida, Illinois, Maryland, Massachusetts, Michigan, Montana, Nevada, New Hampshire, Pennsylvania and Washington) require that all parties consent when one party wants to record a telephone conversation. The telephone recording laws in other states, like federal law, require only one party to be aware of the recording.

The Communications Assistance for Law Enforcement Act may require that the Company undertake material modifications to its platforms and processes to permit wiretapping and other access for law enforcement personnel.

Under various Orders of the Federal Communications Commission, including its Report and Order and Further Notice of Proposed Rulemaking in Docket Number WC 04-36, dated June 27, 2006, the Company may be required to make material retroactive and prospective contributions to funds intended to support Universal Service, Telecommunications Relay Service, Local Number Portability, the North American Numbering Plan and the budget of the Federal Communications Commission.

Laws in most states of the United States of America may require registration or licensing of one or more subsidiaries of the Company, and may impose additional taxes, fees or telecommunications surcharges on the provision of the Company's services which the Company may not be able to pass through to customers.

In addition, there are a large number of federal and state legislative proposals related to our business. It is not possible to predict whether, or when, such legislation might be adopted, and certain proposals, if adopted, could result in a decrease in user registrations and revenue.

We comply with existing law and intend to fully comply with all future laws and regulations that may govern our industry. We have dedicated internal resources and hired outside professionals who regularly establish, review and maintain policies and procedures to reduce the risk of noncompliance. Nevertheless, these laws may impose significant additional costs on our business or subject us to additional liability, if we failed to fully comply, even if such failure was unintentional.

The acquisition of Internet domains generally is governed by Internet regulatory bodies, predominantly the Internet Corporation for Assigned Names and Numbers (ICANN). The regulation of Internet domains in the United States and in foreign countries is subject to change. ICANN and other regulatory bodies could establish



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additional requirements for previously owned Internet domains or modify the requirements for Internet domains. Furthermore, ICANN has and will likely continue to make changes to the scope of domain products available to the marketplace that could have an impact on the competition for premium domain sales.

Compliance with complex foreign and U.S. laws and regulations that apply to our international operations increases our cost of doing business in international jurisdictions and could interfere with our ability to offer our products and services to one or more countries or expose us or our employees to fines and penalties. Our continued international expansion also subjects us to increased foreign currency exchange rate risks and will require additional management attention and resources. We cannot assure you that we will be successful in our international expansion.

We post a privacy policy which describes our practices concerning the use and disclosure of any user data collected or submitted via our web sites. Any failure by us to comply with our posted privacy policies, Federal Trade Commission requirements or other federal, state or international privacy or direct marketing laws and regulations could result in governmental or regulatory investigations that could potentially harm our businesses, operational results and overall financial condition.

### **Employees**

As of December 31, 2012, we employed a total of 331 full-time employees. We have never had a work stoppage, and none of our employees are represented by a labor union. We consider our employee relationships to be positive. If we were unable to retain our key employees or we were unable to maintain adequate staffing of qualified employees, particularly during peak sales seasons, our business would be adversely affected.

### **Web site**

Our web site, [www.marchex.com](http://www.marchex.com), provides access, without charge, to our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such materials are electronically filed with the Securities and Exchange Commission. To view these filings, please go to our web site and click on [Investor Relations](#) and then click on [SEC Filings](#).

## **ITEM 1A. RISK FACTORS**

An investment in our Class B common stock involves various risks, including those mentioned below and those that are discussed from time to time in our other periodic filings with the SEC. Investors should carefully consider these risks, along with the other information contained in this report, before making an investment decision regarding our stock. There may be additional risks of which we are currently unaware, or which we currently consider immaterial. All of these risks could have a material adverse effect on our business, financial condition, results of operations, and the value of our stock.

### **Risks Relating to the Proposed Spin-off Transaction**

**The proposed spin-off of our mobile and call advertising business and domain and advertising marketplace business into two distinct publicly traded companies may not be completed on the terms or timeline currently contemplated, if at all.**

In early November 2012, we announced our intention to pursue the separation of our mobile and call advertising business and domain and advertising marketplace business into two distinct publicly traded companies (the [Proposed Spin-off Transaction](#) ). We are actively engaged in planning for the Proposed Spin-off Transaction. We expect to incur expenses in connection with the Proposed Spin-off Transaction and any delays in the anticipated completion of the Proposed Spin-off Transaction may increase these expenses. Unanticipated developments could delay or negatively impact the Proposed Spin-off Transaction, including those related to the

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filing and effectiveness of appropriate filings with the SEC, obtaining favorable tax rulings and or opinions regarding the tax-free nature of the transaction to us and to our stockholders, receipt of regulatory approvals, completing further due diligence as appropriate, and changes in market conditions, among other things. In addition, consummation of the Proposed Spin-off Transaction will require final approval from our Board of Directors. Therefore, we cannot assure that we will be able to complete the Proposed Spin-off Transaction on the terms or on the timeline that we announced, if at all.

**The post-distribution value of our Class B common stock following completion of the Proposed Spin-off Transaction may not equal or exceed the pre-distribution value of our Class B common stock.**

Following completion of the Proposed Spin-off Transaction, our Class B common stock will continue to be listed and traded on the NASDAQ Global Select Market. We cannot assure you that the trading price of our Class B common stock after the distribution, as adjusted for any changes in the capitalization of Marchex, will be equal to or greater than the trading price of our Class B common stock prior to the distribution. Until the market has fully evaluated the business of Marchex without the business subject to the spin-off, the price at which our Class B common stock trades may fluctuate significantly. These changes may not meet some stockholders' investment strategies, which could cause investors to sell their shares of our Class B common stock. Excessive selling could cause the relative market price of our Class B common stock to decrease following completion of the Proposed Spin-off Transaction.

**The proposed spin-off of our domain and advertising marketplace may require significant time and attention of our management, may not achieve the intended results, and may present difficulties that could have an adverse effect on us.**

Execution of the Proposed Spin-off Transaction will require significant time and attention from management, which may distract management from the operation of our business and the execution of our other initiatives. Our employees may also be distracted due to uncertainty about their future roles with the separate company pending the completion of the spin-off transaction. Although the Proposed Spin-off Transaction is intended to be a tax-free pro rata distribution to our stockholders, these types of transactions are complex and there are no assurances that there will not be adverse tax liabilities in connection therewith. Further, if the spin-off transaction is completed, the transaction may not achieve the intended results. Any such difficulties could have a material adverse effect on our financial condition, results of operations or cash flows.

**If the proposed spin-off is completed, our operational and financial profile will change and we will be a smaller, less diversified company.**

If completed, the Proposed Spin-off Transaction will result in Marchex being a smaller, less diversified company focused on the mobile and call advertising business, which represents a narrower business focus than we currently have. We will have a more limited business with greater concentration in the commercial market and may be more vulnerable to changing market conditions, which could materially and adversely affect our business, financial condition and results of operations. In addition, the diversification of revenues, costs, and cash flows will diminish. As a result, it is possible that our results of operations, cash flows, working capital and financing requirements may be subject to increased volatility and it may be difficult or more expensive for us to obtain financing. Our operations may also be impacted by a limited ability to attract new employees in a timely manner.

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### **Risks Relating to Our Company**

#### **We have largely incurred net losses since our inception, and we may incur net losses in the foreseeable future.**

We had an accumulated deficit of \$173.0 million as of December 31, 2012. Our net expenses may increase based on the initiatives we undertake which for instance, may include increasing our sales and marketing activities, hiring additional personnel, incurring additional costs as a result of being a public company, acquiring additional businesses and making additional equity grants to our employees.

#### **We are dependent on certain distribution partners, for distribution of our services, and we derive a significant portion of our total revenue through these distribution partners. A loss of distribution partners or a decrease in revenue from certain distribution partners could adversely affect our business.**

A relatively small number of distribution partners currently deliver a significant percentage of calls and traffic to our advertisers, although no one distribution partner accounts for in excess of 10% of our revenues. Our existing agreements with many of our other larger distribution partners permit either company to terminate without penalty on short notice and are primarily structured on a variable-payment basis, under which we make payments based on a specified percentage of revenue or based on the number of paid phone calls or click-throughs. We intend to continue devoting resources in support of our larger distribution partners, but there are no guarantees that these relationships will remain in place over the short-or long-term. In addition, we cannot be assured that any of these distribution partners will continue to generate current levels of revenue for us or that we will be able to maintain the applicable variable payment terms at their current levels. A loss of any of these distribution partners or a decrease in revenue due to lower calls and traffic or less favorable variable payment terms from any one of these distribution relationships could have a material adverse effect on our business, financial condition and results of operations.

Companies distributing advertising through mobile or online Internet have experienced, and will likely continue to experience, consolidation. This consolidation has reduced the number of partners that control the mobile and online advertising outlets with the most user calls and traffic. According to the comScore qSearch analysis of the U.S. search marketplace for December 2012, Yahoo! and Microsoft accounted for 12.2% and 16.3%, respectively, of the core search market in the United States and Google accounted for 66.7%. As a result, the larger distribution partners have greater control over determining the market terms of distribution, including placement of call and click-based advertisements and cost of placement. In addition, many participants in the performance-based advertising and search marketing industries control significant portions of mobile and online traffic that they deliver to advertisers. We do not believe, for example, that Yahoo! and Google are as reliant as we are on a third party distribution network to deliver their services. This gives these companies a significant advantage over us in delivering their services, and with a lesser degree of risk.

#### **We rely on certain advertiser reseller partners and agencies, including YP (through our contract with AT&T's subsidiary Yellowpages.com LLC d/b/a AT&T Interactive which is included in a newly formed business unit YP Holdings, LLC), hibu (formerly Yellowbook Inc.), The Cobalt Group, Super Media, Inc., Yodle and Yellow Media, Inc. for the purchase of various advertising and marketing services, as well as to provide us with a large number of advertisers. A loss of certain advertiser reseller partners and agencies or a decrease in revenue from these reseller partners could adversely affect our business. Such advertisers are subject to varying terms and conditions which may result in claims or credit risks to us.**

We benefit from the established relationships and national sales teams that certain of our reseller partners, who are leading reseller partners of advertisers and advertising agencies, have in place throughout the U.S. and international markets. These advertiser reseller partners and agencies refer or bring advertisers to us for the purchase of various advertising products and services. We derive a sizeable portion of our total revenue through these advertiser reseller partners and agencies. A loss of certain advertiser reseller partners and agencies or a decrease in revenue from these clients could adversely affect our business. YP is our largest advertiser reseller



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partner and was responsible for 27% of our total revenues for the year ended December 31, 2012. In April of 2012, AT&T sold of a majority stake in its yellow pages business unit YP Holdings, LLC (including AT&T Interactive) to a third party. We are uncertain whether such a divestiture will occur in an orderly fashion and whether it will impact our business relationship with YP. We cannot predict whether our business with YP in the future will continue at or near current levels and any decrease in such levels could have a material adverse impact on our business and results of operations.

These advertisers may in certain cases be subject to negotiated terms and conditions separate from those applied to online clients accepted and processed through our automated advertiser management platform. In some cases, the applicable contract terms may be the result of legacy or industry association documentation or simply customized advertising solutions for large reseller partners and agencies. In any case, as a consequence of such varying terms and conditions, we may be subject to claims or credit risks that we may otherwise mitigate more efficiently across our automated advertiser management platform.

These claims and risks may vary depending on the nature of the aggregated client base. Among other claims, we may be subject to disputes based on third party tracking information or analysis. We may also be subject to differing credit profiles and risks based on the agency relationship associated with these advertisers. For such advertisers, payment may be made on an invoice basis, unlike our retail platform which in many instances is paid in advance of the service. In some limited circumstances we may also have accepted individual advertiser payment liability in place of liability of the advertising agency or media advisor.

**We received approximately 50% and 51% of our revenue from our five largest customers for the years ended December 31, 2011 and 2012, respectively, and the loss of one or more of these customers could adversely impact our results of operations and financial condition.**

Our five largest customers accounted for approximately 50% and 51% of our total revenues for the years ended December 31, 2011 and 2012, respectively. YP is our largest customer and was responsible for 27% of our total revenues for the year ended December 31, 2012 and 36% of accounts receivable at December 31, 2012. Certain of these customers are not subject to long term contracts with us and are generally able to reduce advertising spending at any time and for any reason. A significant reduction in advertising spending by our largest customers, or the loss of one or more of these customers, if not replaced by new customers or an increase in business from existing customers, would adversely affect revenues. This could have a material adverse effect on our results of operations and financial condition.

**Our large customers have substantial negotiating leverage, which may require that we agree to terms and conditions that may have an adverse effect on our business.**

Our large customers have substantial purchasing power and leverage in negotiating contractual arrangements with us. These customers may seek for us to develop additional features, may require penalties for failure to deliver such features, may seek discounted product or service pricing and may seek more favorable contractual terms. As we sell more products and services to this class of customer, we may be required to agree to such terms and conditions. Such large customers also have substantial leverage in negotiating resolution of any disagreements or disputes that may arise. Any of the foregoing factors could result in a material adverse effect on our business, financial condition and results of operations.

**If some of our customers experience financial distress or suffer disruptions in their business, their weakened financial position could negatively affect our own financial position and results.**

We have a diverse customer base and, at any given time, one or more customers may experience financial distress, file for bankruptcy protection, go out of business, or suffer disruptions in their business. If a customer with whom we do a substantial amount of business experiences financial difficulty or suffers disruptions in their

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business, it could delay or jeopardize the collection of accounts receivable, result in significant reductions in services provided by us and may have a material adverse effect on our results of operations and liquidity.

**We may incur liabilities for the activities of our advertisers, reseller partners, distribution partners and other users of our services, which could adversely affect our business.**

Many of our advertisement generation and distribution processes are automated. In some cases, advertisers or reseller partners use our online tools and account management systems to create and submit advertiser listings and in other cases we create and submit advertising listings on behalf of our advertisers or reseller partners. These advertiser listings are submitted in a bulk data feed or through the distribution partners' user interface. Although we monitor our distribution partners on an ongoing basis primarily for traffic quality, these partners control the distribution of the advertiser listings provided in the data feed or user interface submissions.

We have a large number of distribution partners who display our advertiser listings on their networks. Our advertiser listings are delivered to our distribution partners in an automated fashion through an XML data feed or data dump or through the distribution partners' user interface. Our distribution partners are contractually required to use the listings created by our advertiser customers in accordance with applicable laws and regulations and in conformity with the publication restrictions in our agreements, which are intended to promote the quality and validity of the traffic provided to our advertisers. Nonetheless, we do not operationally control or manage these distribution partners and any breach of these agreements on the part of any distribution partner or its affiliates could result in liability for our business. These agreements include indemnification obligations on the part of our distribution partners, but there is no guarantee that we would be able to collect against offending distribution partners or their affiliates in the event of a claim under these indemnification provisions. Alternatively, we may incur substantial costs as part of our indemnification obligations to distribution partners for liability they may incur as a result of displaying content we have provided them.

We do not conduct a manual editorial review of a substantial number of the advertiser listings directly submitted by advertisers or reseller partners online, nor do we manually review the display of the vast majority of the advertiser listings by our distribution partners submitted to us by XML data feeds or data dumps or the distribution partners' user interface. Likewise, in cases where we provide editorial or value-added services for our large reseller partners or agencies, such as ad creation and optimization for local advertisers or landing pages and micro-sites for pay-for-call customers, we rely on the content and information provided to us by these agents on behalf of their individual advertisers. We do not investigate the individual business activities of these advertisers other than the information provided to us or in some cases review of advertiser web sites. We may not successfully avoid liability for unlawful activities carried out by our advertisers or reseller partners and other users of our services or unpermitted uses of our advertiser listings by distribution partners and their affiliates.

Our potential liability for unlawful activities of our advertisers and other users of our services or unpermitted uses of our advertiser listings and advertising services and platform by distribution partners and reseller partners and agencies could require us to implement measures to reduce our exposure to such liability, which may require us, among other things, to spend substantial resources, to discontinue certain service offerings or to terminate certain distribution partner relationships. For example, as a result of the actions of advertisers in our network, we may be subject to private or governmental actions relating to a wide variety of issues, such as privacy, gambling, promotions, and intellectual property ownership and infringement. Under agreements with certain of our larger distribution partners, we may be required to indemnify these distribution partners against liabilities or losses resulting from the content of our advertiser listings, or resulting from third party intellectual property infringement claims. Although our advertisers agree to indemnify us with respect to claims arising from these listings, we may not be able to recover all or any of the liabilities or losses incurred by us as a result of the activities of our advertisers.

Our insurance policies may not provide coverage for liability arising out of activities of users of our services. In addition, our reliance on some content and information provided to us by our large advertiser reseller partners and agencies may expose us to liability not covered by our insurance policies. Furthermore, we may not

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be able to obtain or maintain adequate insurance coverage to reduce or limit the liabilities associated with our businesses. Any costs incurred as a result of such liability or asserted liability could have a material adverse effect on our business, operating results and financial condition.

**If we do not maintain and grow a critical mass of advertisers and distribution partners, the value of our services could be adversely affected.**

Our success depends, in large part, on the maintenance and growth of a critical mass of advertisers and distribution partners and a continued interest in our pay-for-call, performance-based advertising, telemarketing analytics and search marketing services. Advertisers will generally seek the most competitive return on investment from advertising and marketing services. Distribution partners will also seek the most favorable payment terms available in the market. Advertisers and distribution partners may change providers or the volume of business with a provider, unless the product and terms are competitive. In this environment, we must compete to acquire and maintain our network of advertisers and distribution partners. If our business is unable to maintain and grow our base of advertisers, our current distribution partners may be discouraged from continuing to work with us, and this may create obstacles for us to enter into agreements with new distribution partners. Our business also in part depends on certain of our large reseller partners and agencies to grow their base of advertisers as these advertisers become increasingly important to our business and our ability to attract additional distribution partners and opportunities. Similarly, if our distribution network does not grow and does not continue to improve over time, current and prospective advertisers and reseller partners and agencies may reduce or terminate this portion of their business with us. Any decline in the number of advertisers and distribution partners could adversely affect the value of our services.

**The mobile advertising market may develop more slowly than expected, which could harm our business.**

If the market for mobile marketing and advertising develops more slowly than we expect, our business could suffer. Our future success is highly dependent on the commitment of advertisers and marketers to mobile communications as an advertising and marketing medium, the willingness of our potential advertisers to outsource their mobile advertising and marketing needs, and our ability to sell our mobile advertising services to reseller partners and agencies. The mobile advertising and marketing market is relatively new and rapidly evolving. Businesses, including current and potential advertisers, may find mobile advertising or marketing to be less effective than traditional advertising media or marketing methods or other technologies for promoting their products and services. As a result, the future demand and market acceptance for mobile marketing and advertising is uncertain. Many of our current or potential advertisers have little or no experience using mobile communications for advertising or marketing purposes and have allocated only a limited portion of their advertising or marketing budgets to mobile communications advertising or marketing, and there is no certainty that they will allocate more funds in the future, if any.

**We are dependent upon the quality of mobile, online, offline and other traffic sources in our network to provide value to our advertisers and the advertisers of our reseller partners, and any failure in our quality control could have a material adverse effect on the value of our services to our advertisers and adversely affect our revenues.**

We utilize certain monitoring processes with respect to the quality of the mobile, online, offline and other traffic sources that we deliver to our advertisers. Among the factors we seek to monitor are sources and causes of low quality phone calls such as unwanted telemarketer calls and clicks such as non-human processes, including robots, spiders or other software, the mechanical automation of clicking, and other types of invalid clicks, click fraud, or click spam, the purpose of which is something other than to view the underlying content. Additionally, we also seek to identify other indicators which may suggest that a user may not be targeted by or desirable to our advertisers. Even with such monitoring in place, there is a risk that a certain amount of low quality mobile, online, offline and other traffic or traffic that is deemed to be less valuable by our advertisers will be delivered to such advertisers, which may be detrimental to those relationships. We have regularly refunded fees that our advertisers had paid to us which were attributed to low quality mobile, online, offline and other traffic. If we are

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unable to stop or reduce low quality Internet traffic and low quality phone calls, these refunds may increase. Low quality mobile, online, offline and other traffic may further prevent us from growing our base of advertisers and cause us to lose relationships with existing advertisers, or become the target of litigation, both of which would adversely affect our revenues.

**We depend on being able to secure enough phone numbers to support our advertisers and other users of our services and any obstacles that we face which prevent us from meeting this demand could adversely affect our business.**

We utilize phone numbers as part of a number of information and analytic services to advertisers, such as our pay-for-call, call tracking and call analytics services. Our services that utilize phone numbers are designed to enable advertisers and other users of our services to utilize mobile, online and offline advertising and to help measure the effectiveness of mobile, online and offline advertising campaigns. We secure a majority of our phone numbers through telecommunication carriers that we have contracted with and a smaller number through the 800 Service Management System, and such telecommunication carriers provide the underlying telephone service. Our telecommunications carriers and telephone number acquisition process are subject to the rules and guidelines established by the Federal Communications Commission. Furthermore, to the extent we offer call recording and pay-for-call services, we may be directly subject to certain telecommunications-related regulations. The Federal Communications Commission and our telecommunication carriers may change the rules and guidelines for securing phone numbers or change the requirements for retaining the phone numbers we have already secured. As a result, we may not be able to secure or retain sufficient phone numbers needed for our services. We may also be limited in the number of available telecommunications carriers or vendors to provide such phone numbers to us in the event of any industry consolidations.

**Our acquisition of certain automated voice and mobile advertising-based technologies is heavily reliant on vendors.**

Certain voice and mobile advertising-based products that we acquired as part of our acquisition of Jingle are heavily reliant on vendors. The free directory product that we provide relies on technology provided by third party vendors that include voice recognition software and business, government and residence data listings. We cannot guarantee that the technology, data and services provided by our third party vendors will be of sufficient quality to meet the demands of our customers and partners. Further, we cannot guarantee that the technologies, data and services will be available to us in the future on acceptable terms, if at all. Any perception by our customers or partners that our voice and mobile advertising-based products are incomplete or not of sufficient quality could lead to a loss in confidence by our customers or partners, which in turn could lead to a decline in revenues. If we are unable to continue maintaining, advancing and improving our voice and mobile advertising-based products, our operating results may be adversely affected.

**We may be subject to intellectual property claims, which could adversely affect our financial condition and ability to use certain critical technologies, divert our resources and management attention from our business operations and create uncertainty about ownership of technology essential to our business.**

Our success depends, in part, on our ability to operate without infringing on the intellectual property rights of others. There can be no guarantee that any of our intellectual property will not be challenged by third parties. We may be subject to patent infringement claims or other intellectual property infringement claims, including claims of trademark infringement in connection with our acquisition of previously-owned Internet domain names and claims of copyright infringement with respect to certain of our proprietary web sites that would be costly to defend and could limit our ability to use certain critical technologies.

The expansion of our digital call advertising business increases the potential intellectual property infringement claims we may be subject to, particularly in light of the large number of patents which have been issued (or are pending) in the telecommunications field over the last several decades, both in the U.S. and

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internationally. Jingle, which we acquired in 2011, was subject to patent infringement claims which were unsuccessful at trial. We recently resolved this matter and obtained a license to the patents at issue.

We believe that a consolidation of patent portfolios by major technology companies and independent asset holding companies may increase the chances of aggressive assertions of patent and other intellectual property claims. Within the technology and online sectors, among other related sectors, we have witnessed various claim holders and alleged rights holders pursue business strategies devoted to extracting settlements or license fees for a wide range of basic and commonly accepted methods and practices. We may be subject to those intellectual property claims in the ordinary course of our business. Also, our partners and customers may also find that they are subject to similar claims, in which case we may be included in any related process or dispute settlement.

Any patent or other intellectual property litigation could negatively impact our business by diverting resources and management attention from other aspects of the business and adding uncertainty as to the ownership of technology, services and property that we view as proprietary and essential to our business. In addition, a successful claim of patent infringement against us and our failure or inability to license the infringed or similar technology on reasonable terms, or at all, could prevent us from using critical technologies which could have a material adverse effect on our business.

**We may need additional funding to meet our obligations and to pursue our business strategy. Additional funding may not be available to us and our financial condition could therefore be adversely affected.**

We may require additional funding to meet our ongoing obligations and to pursue our business strategy, which may include the selective acquisition of businesses and technologies. In addition, we have incurred and we may incur certain obligations in the future. There can be no assurance that if we were to need additional funds to meet these obligations that additional financing arrangements would be available in amounts or on terms acceptable to us, if at all. Furthermore, if adequate additional funds are not available, we will be required to delay, reduce the scope of, or eliminate material parts of the implementation of our business strategy, including potential additional acquisitions or internally-developed businesses.

**Our acquisitions could divert management's attention, cause ownership dilution to our stockholders, cause our earnings to decrease and be difficult to integrate.**

Our business strategy includes identifying, structuring, completing and integrating acquisitions. Acquisitions in the technology and Internet sectors involve a high degree of risk. We may also be unable to find a sufficient number of attractive opportunities to meet our objectives which include revenue growth, profitability and competitive market share. Our acquired companies may have histories of net losses and may expect net losses for the foreseeable future. Acquisitions are accompanied by a number of risks that could harm our business, operating results and financial condition:

We could experience a substantial strain on our resources, including time and money, and we may not be successful;

Our management's attention could be diverted from our ongoing business concerns;

While integrating new companies, we may lose key executives or other employees of these companies;

We may issue shares of our Class B common stock as consideration for acquisitions which may result in ownership dilution to our stockholders;

We could fail to successfully integrate our financial and management controls, technology, reporting systems and procedures, or adequately expand, train and manage our workforce;

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We could experience customer dissatisfaction or performance problems with an acquired company or technology;

We could become subject to unknown or underestimated liabilities of an acquired entity or incur unexpected expenses or losses from such acquisitions;

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We could incur possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances, any of which could harm our business; and

We may be exposed to investigations and/or audits by federal, state or other taxing authorities. Consequently, we might not be successful in integrating any acquired businesses, products or technologies, and might not achieve anticipated revenue and cost benefits.

### **Our expanding international operations subject us to additional risks and uncertainties and we may not be successful with our strategy to continue to expand such operations.**

One potential area of growth for us is in international markets. We have initiated operations, through our subsidiaries, in Ireland and the United Kingdom. Our international expansion and the integration of international operations present unique challenges and risks. Compliance with complex foreign and U.S. laws and regulations that apply to our international operations increases our cost of doing business in international jurisdictions and could interfere with our ability to offer our products and services to one or more countries or expose us or our employees to fines and penalties. Our continued international expansion also subjects us to increased foreign currency exchange rate risks and will require additional management attention and resources. We cannot assure you that we will be successful in our international expansion. There are risks inherent in conducting business in international markets, including the need to localize our products and services to foreign customers preferences and customs, difficulties in managing operations due to language barriers, distance, staffing and cultural differences, application of foreign laws and regulations to us, tariffs and other trade barriers, fluctuations in currency exchange rates, establishing management systems and infrastructures, reduced protection for intellectual property rights in some countries, changes in foreign political and economic conditions, and potentially adverse tax consequences. Our failure to address these risks adequately could materially and adversely affect our business, revenue, results of operations and financial condition.

### **The loss of our senior management, including our founders, could harm our current and future operations and prospects.**

We are heavily dependent upon the continued services of Russell C. Horowitz, our chairman and chief executive officer, and the other members of our senior management team. Each member of our senior management team is an at-will employee and may voluntarily terminate his employment with us at any time with minimal notice. Following any termination of employment, each of these employees would only be subject to a twelve-month non-competition and non-solicitation obligation with respect to our customers and employees under our standard confidentiality agreement.

Further, as of December 31, 2012, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founders, together controlled 90% of the combined voting power of our outstanding capital stock. Their collective voting control is not tied to their continued employment with Marchex. The loss of the services of any member of our senior management, including our founders, for any reason, or any conflict among our founders, could harm our current and future operations and prospects.

### **We may have difficulty retaining current personnel as well as attracting and retaining additional qualified, experienced, highly skilled personnel, which could adversely affect the implementation of our business plan.**

Our performance is largely dependent upon the talents and efforts of highly skilled individuals. In order to fully implement our business plan, we will need to retain our current qualified personnel, as well as attract and retain additional qualified personnel. Thus, our success will in significant part depend upon our retention of current personnel as well as the efforts of personnel not yet identified and upon our ability to attract and retain highly skilled managerial, engineering, sales and marketing personnel. We are also dependent on managerial and

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technical personnel to the extent they may have knowledge or information about our businesses and technical systems that may not be known by our other personnel. There can be no assurance that we will be able to attract and retain necessary personnel. The failure to hire and retain such personnel could adversely affect the implementation of our business plan.

**If we are unable to obtain and maintain adequate insurance, our financial condition could be adversely affected in the event of uninsured or inadequately insured loss or damage. Our ability to effectively recruit and retain qualified officers and directors may also be adversely affected if we experience difficulty in maintaining adequate directors and officers liability insurance.**

We may not be able to obtain and maintain insurance policies on terms affordable to us that would adequately insure our business and property against damage, loss or claims by third parties. To the extent our business or property suffers any damages, losses or claims by third parties that are not covered or adequately covered by insurance, our financial condition may be materially adversely affected.

We currently have directors and officers liability insurance. If we are unable to maintain sufficient insurance as a public company to cover liability claims made against our officers and directors, we may not be able to retain or recruit qualified officers and directors to manage our company, which could have a material adverse effect on our operations.

**It may be difficult for us to retain or attract qualified officers and directors, which could adversely affect our business and our ability to maintain the listing of our Class B common stock on the NASDAQ Global Select Market.**

We may be unable to attract and retain qualified officers, directors and members of board committees required to provide for our effective management as a result of changes in the rules and regulations which govern publicly-held companies, including, but not limited to, certifications from executive officers and requirements for financial experts on boards of directors. The perceived increased personal risk associated with these changes may deter qualified individuals from accepting these roles. Further, applicable rules and regulations of the Securities and Exchange Commission and the NASDAQ Stock Market heighten the requirements for board or committee membership, particularly with respect to an individual's independence from the corporation and level of experience in finance and accounting matters. We may have difficulty attracting and retaining directors with the requisite qualifications. If we are unable to attract and retain qualified officers and directors, our business and our ability to maintain the listing of our shares of Class B common stock on the NASDAQ Global Select Market could be adversely affected.

**If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud, which could harm our brand and operating results.**

Effective internal controls are necessary for us to provide reliable and accurate financial reports and effectively prevent fraud. We have devoted significant resources and time to comply with the internal control over financial reporting requirements of the Sarbanes-Oxley Act of 2002. In addition, Section 404 under the Sarbanes-Oxley Act of 2002 requires that we assess and our auditors attest to the effectiveness of our controls over financial reporting. Our current and future compliance with the annual internal control report requirement will depend on the effectiveness of our financial reporting and data systems and controls across our operating subsidiaries. We expect these systems and controls to become increasingly complex to the extent that we integrate acquisitions and our business grows. To effectively manage this growth, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. We cannot be certain that these measures will ensure that we design, implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation or operation, could harm our operating results or cause us to fail to meet our financial reporting obligations. Inadequate internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock and our access to capital.



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**Impairment of goodwill and other intangible assets would result in a decrease in earnings.**

Current accounting rules require that goodwill and other intangible assets with indefinite useful lives be tested for impairment at least annually. These rules also require that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Events and circumstances considered in determining whether the carrying value of amortizable intangible assets and goodwill may not be recoverable include, but are not limited to, significant changes in performance relative to expected operating results, significant changes in the use of the assets, significant negative industry or economic trends, or a significant decline in our stock price and/or market capitalization for a sustained period of time. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, the quarterly amortization expense is increased or decreased. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, amortization expense is increased or decreased.

We recorded a substantial non-cash impairment charge for goodwill and intangible assets during the fourth quarter of 2008 as a result of the impact of the adverse economic environment including the deterioration in the equity and credit markets.

We recorded a non-cash impairment charge for goodwill of \$16.7 million during the fourth quarter of 2012 within the Archeo segment as a result of lower projected revenue growth rates and profitability levels compared to historical results and other market-based factors.

We may be required to record a future charge to earnings in our financial statements during the period in which any additional impairment of our goodwill or amortizable intangible assets is determined. Any impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

**We may be required to establish a valuation allowance against our deferred tax assets.**

Factors in our ability to realize a tax benefit from our deferred tax assets include tax attributes and operating results of acquired businesses, the nature, extent and periods that temporary differences are expected to reverse and our expectations about future operating results. We regularly review our deferred tax assets to assess whether or not it is more likely than not that the deferred tax assets will be realized, and if necessary, establish a valuation allowance for portions of such assets to reduce the carrying value. At the end of the fourth quarter of 2012, we recognized a partial valuation allowance of \$16.4 million on our federal deferred tax assets which reduced our net deferred assets to \$28.5 million. If we determine that our deferred tax assets will not result in a future tax benefit, an additional valuation allowance may be recorded with a corresponding charge to net income. Such charges may have a material adverse effect on our results of operations or financial condition. The likelihood of recording such a valuation allowance may be impacted by our acquisitions, or by our proposed separation of Archeo into a separate public company, and increases during periods of economic downturn.

**We may not be able to realize the intended and anticipated benefits from our acquisitions of Internet domain names in part due to our increasing business focus on digital call advertising products, which could affect the value of these acquisitions to our business and our ability to meet our financial obligations and targets.**

We may not be able to realize the intended and anticipated benefits from our acquisitions of Internet domain names in part due to our increasing focus on digital call advertising products. These intended and anticipated benefits included increasing our cash flow from operations, broadening our distribution offerings and delivering services that strengthen our advertiser relationships.

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If the acquired assets are not integrated into our business as we had anticipated, we may not be able to achieve these benefits or realize the value paid for our acquisitions of Internet domain names, which could materially harm our business, financial condition and results of operations.

**We do not control the means by which users access our web sites, and material changes to current navigation practices or technologies or marketing practices or significant increases in our marketing costs could result in a material adverse effect on our business.**

The success of our proprietary web site traffic sources depends in large part upon consumer access to our web sites. Consumers access our web sites primarily through the following methods: directly accessing our web sites by typing descriptive keywords or keyword strings into the uniform resource locator (URL) address box of an Internet browser; accessing our web sites by clicking on bookmarked web sites; and accessing our web sites through search engines and directories.

Each of these methods requires the use of a third party product or service, such as an Internet browser or search engine application or directory. Internet browsers may provide alternatives to the URL address box to locate web sites, and search engines may from time to time change and establish rules regarding the indexing and optimization of web sites. We also market certain web sites through search engine applications. Historically, we have limited our search engine marketing to less than five leading search engines.

Product developments and market practices for these means of access to our web sites are not within our control. We may experience a decline in traffic to our web sites if third party browser technologies or search engine methodologies and rules are changed to our disadvantage. We have experienced abrupt search engine algorithm and policy changes in the past. We expect the search engine applications we utilize to market and drive users to our web sites to continue to periodically change their algorithms, policies and technologies. These changes may result in an interruption in users ability to access our web sites or impair our ability to maintain and grow the number of users who visit our web sites. We may also be forced to significantly increase marketing expenditures in the event that market prices for online advertising and paid-listings escalate. Any of these changes could have a material adverse effect on our business.

**We may experience unforeseen liabilities in connection with our acquisitions of Internet domain names or arising out of third party domain names included in our distribution network, which could negatively impact our financial results.**

Certain of our acquisitions involved the acquisition of a large number of previously-owned Internet domain names. Furthermore, we have separately acquired and may acquire in the future additional previously-owned Internet domain names. In some cases, these acquired names may have trademark significance that is not readily apparent to us or is not identified by us in the bulk purchasing process. As a result we may face demands by third party trademark owners asserting infringement or dilution of their rights and seeking transfer of acquired Internet domain names under the Uniform Domain Name Dispute Resolution Policy administered by ICANN or actions under the U.S. Anti-Cybersquatting Consumer Protection Act. Additionally, we display pay-for-call or pay-per-click listings on third party domain names and third party web sites that are part of our distribution network, which also could subject us to a wide variety of civil claims including intellectual property ownership and infringement.

We intend to review each claim or demand which may arise from time to time on its merits on a case-by-case basis with the assistance of counsel and we intend to transfer any rights acquired by us to any party that has demonstrated a valid prior right or claim. We cannot, however, guarantee that we will be able to resolve these disputes without litigation. The potential violation of third party intellectual property rights and potential causes of action under consumer protection laws may subject us to unforeseen liabilities including injunctions and judgments for money damages.

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### **Risks Relating to Our Business and Our Industry**

**If we are unable to compete in the highly competitive performance-based advertising and search marketing industries, we may experience reduced demand for our products and services.**

We operate in a highly competitive and changing environment. We principally compete with other companies which offer services in the following areas:

sales to advertisers of pay-for-call services;

sales to advertisers of pay-per-click services;

aggregation or optimization of online advertising for distribution through mobile and online search engines and applications, product shopping engines, directories, web sites or other offline outlets;

provision of local and vertical web sites containing information and user feedback designed to attract users and help consumers make better, more informed local decisions, while providing targeted advertising inventory for advertisers;

delivery of pay-for-call advertising to end users or customers of advertisers through mobile and online destination web sites or other offline distribution outlets;

delivery of online advertising to end users or customers of advertisers through mobile and online destination web sites or other offline distribution outlets;

local search sales training;

services and outsourcing of technologies that allow advertisers to manage their advertising campaigns across multiple networks and track the success of these campaigns;

third party domain monetization; and

sales to advertisers of call tracking, call analytics, and presence management services.

Although we currently pursue a strategy that allows us to potentially partner with all relevant companies in the industry, there are certain companies in the industry that may not wish to partner with us. Despite the fact that we currently work with several of our potential competitors, there are no guarantees that these companies will continue to work with us in the future.

We currently or potentially compete with a variety of companies, including Google, IAC/InterActiveCorp, Microsoft, Yahoo! and ReachLocal. Many of these actual or perceived competitors also currently or may in the future have business relationships with us, particularly in distribution. However, such companies may terminate their relationships with us. Furthermore, our competitors may be able to secure agreements with us on more favorable terms, which could reduce the usage of our services, increase the amount payable to our distribution partners, reduce total revenue and thereby have a material adverse effect on our business, operating results and financial condition. We expect competition to intensify in the future because current and new competitors can enter our market with little difficulty. The barriers to entering our market are relatively

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low. In fact, many current Internet and media companies presently have the technical capabilities and advertiser bases to enter the search marketing services industry. Further, if the consolidation trend continues among the larger media and search engine companies with greater brand recognition, the share of the market remaining for smaller search marketing services providers could decrease, even though the number of smaller providers could continue to increase. These factors could adversely affect our competitive position.

Some of our competitors, as well as potential entrants into our market, may be better positioned to succeed in this market. They may have:

longer operating histories;

more management experience;

an employee base with more extensive experience;

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better geographic coverage;

larger customer bases;

greater brand recognition; and

significantly greater financial, marketing and other resources.

Currently, and in the future, as the use of the Internet and other mobile and online services increases, there will likely be larger, more well-established and well-financed entities that acquire companies and/or invest in or form joint ventures in categories or countries of interest to us, all of which could adversely impact our business. Any of these trends could increase competition and reduce the demand for any of our services.

**We face competition from traditional media companies, and we may not be included in the advertising budgets of large advertisers, which could harm our operating results.**

In addition to Internet companies, we face competition from companies that offer traditional media advertising opportunities. Most large advertisers have set advertising budgets, a very small portion of which is allocated to Internet advertising. We expect that large advertisers will continue to focus most of their advertising efforts on traditional media. If we fail to convince these companies to spend a portion of their advertising budgets with us, or if our existing advertisers reduce the amount they spend on our programs, our operating results would be harmed.

**If we are not able to respond to the rapid technological change characteristic of our industry, our products and services may cease to be competitive.**

The market for our products and services is characterized by rapid change in business models and technological infrastructure, and we will need to constantly adapt to changing markets and technologies to provide new and competitive products and services. If we are unable to ensure that our users, advertisers, reseller partners, and distribution partners have a high-quality experience with our products and services, then they may become dissatisfied and move to competitors' products and services. Accordingly, our future success will depend, in part, upon our ability to develop and offer competitive products and services for both our target market and for applications in new markets. We may not, however, be able to successfully do so, and our competitors may develop innovations that render our products and services obsolete or uncompetitive.

**Our technical systems are vulnerable to interruption and damage that may be costly and time-consuming to resolve and may harm our business and reputation.**

A disaster could interrupt our services for an indeterminate length of time and severely damage our business, prospects, financial condition and results of operations. Our systems and operations are vulnerable to damage or interruption from:

fire;

floods;

network failure;

hardware failure;

software failure;

power loss;

telecommunications failures;

break-ins;

terrorism, war or sabotage;

computer viruses;

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denial of service attacks;

penetration of our network by unauthorized computer users and hackers and other similar events;

natural disasters, including, but not limited to, hurricanes, tornadoes, and earthquakes; and

other unanticipated problems.

We may not have developed or implemented adequate protections or safeguards to overcome any of these events. We also may not have anticipated or addressed many of the potential events that could threaten or undermine our technology network. Any of these occurrences could cause material interruptions or delays in our business, result in the loss of data or render us unable to provide services to our customers. In addition, if a person is able to circumvent our security measures, he or she could destroy or misappropriate valuable information, including sensitive customer information, or disrupt our operations. We have deployed firewall hardware intended to thwart hacker attacks. Although we maintain property insurance and business interruption insurance, our insurance may not be adequate to compensate us for all losses that may occur as a result of a catastrophic system failure or other loss, and our insurers may not be able or may decline to do so for a variety of reasons. If we fail to address these issues in a timely manner, we may lose the confidence of our advertisers, reseller partners, and distribution partners, our revenue may decline and our business could suffer. In addition, as we expand our service offerings and enter into new business areas, we may be required to significantly modify and expand our software and technology platform. If we fail to accomplish these tasks in a timely manner, our business and reputation will likely suffer. Furthermore, some of these events could disrupt the economy and/or our customers business activities and in turn materially affect our operating results.

**We rely on third party technology, platforms, carriers, communications providers, and server and hardware providers, and a failure of service by these providers could adversely affect our business and reputation.**

We rely upon third party colocation providers to host our main servers. If these providers are unable to handle current or higher volumes of use, experience any interruption in operations or cease operations for any reason or if we are unable to agree on satisfactory terms for continued hosting relationships, we would be forced to enter into a relationship with other service providers or assume hosting responsibilities ourselves. If we are forced to switch hosting facilities, we may not be successful in finding an alternative service provider on acceptable terms or in hosting the computer servers ourselves. We may also be limited in our remedies against these providers in the event of a failure of service. In the past, we have experienced short-term outages in the service maintained by one of our colocation providers.

We also rely on a select group of third party providers for components of our technology platform and support for our advertising and call-based services, such as hardware and software providers, telecommunications carriers and Voice over Internet Protocol (VoIP) providers, credit card processors and domain name registrars. As a result, key operational resources of our business are concentrated with a limited number of third party providers. A failure or limitation of service or available capacity by any of these third party providers could adversely affect our business and reputation. Furthermore, if any of these significant providers are unable to provide the levels of service and dedicated resources over time that we required in our business, we may not be able to replace certain of these providers in a manner that is efficient, cost-effective or satisfactory to our customers, and as a result our business could be materially and adversely affected.

**If our security measures are breached or are perceived as not being secure, we may lose advertisers, reseller partners and distribution partners and we may incur significant legal and financial exposure.**

We store and transmit data and information about our advertisers, reseller partners, distribution partners and their respective users. We deploy security measures to protect this data and information, as do third parties we utilize to assist in data and information storage. Our security measures and those of the third parties we partner with to assist in data and information storage may suffer breaches. Security breaches of our data storage systems

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or our third party colocation and technology providers we utilize to store data and information relating to our advertisers, reseller partners, distribution partners and their respective users could expose us to significant potential liability. In addition, security breaches, actual or perceived, could result in the loss of advertisers, reseller partners and distribution partners that could potentially have an adverse effect on our business.

**We may not be able to protect our intellectual property rights, which could result in our competitors marketing competing products and services utilizing our intellectual property and could adversely affect our competitive position.**

Our success and ability to compete effectively are substantially dependent upon our internally developed and acquired technology and data resources, which we protect through a combination of copyright, trade secret, and patent and trademark law. To date, we have had issued or have applications pending for the following patents:

U.S. Patent Number 7,668,950 entitled *Automatically Updating Performance-Based Online Advertising System and Method* was issued February 23, 2010.

U.S. Nonprovisional Patent Application Number 11/985,188 entitled *Method and System for Tracking Telephone Calls* was filed on November 14, 2007 and a corresponding divisional Patent Application Number 13/294,436 was filed November 11, 2011.

U.S. Patent Number 6,822,663 entitled *Transform Rule Generator for Web-Based Markup Languages* was issued November 23, 2004.

U.S. Nonprovisional Patent Application Number 12/512,821 entitled *Facility for Reconciliation of Business Records Using Genetic Algorithms* was filed on July 30, 2009.

U.S. Nonprovisional Patent Application Number 12/829,372 entitled *System and Method to Direct Telephone Calls to Advertisers* and U.S. Nonprovisional Patent Application Number 12/829,373 entitled *System and Method for Calling Advertised Telephone Numbers on a Computing Device* and U.S. Patent Number 8,259,915 (issued September 4, 2012) entitled *System and Method to Analyze Calls to Advertised Telephone Numbers* were all filed on July 1, 2010. Respective corresponding PCT Application Numbers PCT/US11/42792, PCT/US11/42812 and PCT/US11/42819 were filed July 1, 2011.

U.S. Nonprovisional Patent Application Number 13/176,709 entitled *Method and System for Automatically Generating Advertising Creatives* was filed July 5, 2011.

U.S. Nonprovisional Patent Application Number 12/844,488 entitled *Systems and Methods for Blocking Telephone Calls* was filed on July 27, 2010 and corresponding PCT Application Number PCT/US11/45403 was filed July 26, 2011.

U.S. Patent Number 7,212,615 entitled *Criteria Based Marketing For Telephone Directory Assistance* was issued May 1, 2007 and owned by Jingle Networks, which we acquired in 2011.

U.S. Patent Number 7,702,084 entitled *Toll-Free Directory Assistance With Preferred Advertisement Listing* was issued April 20, 2010.



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U.S. Patent Number 7,961,861 entitled Telephone Search Supported By Response Location Advertising was issued June 14, 2011 and corresponding European Application Number 5826299.99 was filed November 29, 2005.

U.S. Nonprovisional Patent Application Number 11/290,148 entitled Telephone Search Supported By Advertising Based On Past History Of Requests was filed November 29, 2005.

U.S. Nonprovisional Patent Application Number 11/291,094 entitled Telephone Search Supported By Keyword Map To Advertising was filed November 29, 2005.

U.S. Patent Number 8,175,231 entitled Toll-Free Directory Assistance With Automatic Selection Of An Advertisement From A Category issued May 8, 2012.

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U.S. Patent Number 8,107,602 entitled Directory Assistance With Data Processing Station issued January 12, 2012.

U.S. Nonprovisional Patent Application Number 13/677,248 entitled System and Method to Customize a Connection Interface for Multimodal Connection to a Telephone Number was filed November 14, 2012.

In the future, additional patents may be filed with respect to internally developed or acquired technologies. Our industry is highly competitive and many individuals and companies have sought to patent processes in the industry. We may decide not to protect certain intellectual properties or business methods which may later turn out to be significant to us. In addition, the patent process takes several years and involves considerable expense. Further, patent applications and patent positions in our industry are highly uncertain and involve complex legal and factual questions due in part to the number of competing technologies. As a result, we may not be able to successfully prosecute these patents, in whole or in part, or any additional patent filings that we may make in the future. We also depend on our trademarks, trade names and domain names. We may not be able to adequately protect our technology and data resources. In addition, intellectual property laws vary from country to country, and it may be more difficult to protect our intellectual property in some foreign jurisdictions in which we may plan to enter. If we fail to obtain and maintain patent or other intellectual property protection for our technology, our competitors could market competing products and services utilizing our technology.

Despite our efforts to protect our proprietary rights, unauthorized parties domestically and internationally may attempt to copy or otherwise obtain and use our services, technology and other intellectual property. We cannot be certain that the steps we have taken will prevent any misappropriation or confusion among consumers and advertisers. If we are unable to protect our intellectual property rights from unauthorized use, our competitive position could be adversely affected.

**We may be involved in lawsuits to protect or enforce our patents, which could be expensive and time consuming.**

We may initiate patent litigation against third parties to protect or enforce our patent rights, and we may be sued by others seeking to invalidate our patents or prevent the issuance of future patents. We may also become subject to interference proceedings conducted in the patent and trademark offices of various countries to determine the priority of inventions. The defense and prosecution, if necessary, of intellectual property suits, interference proceedings and related legal and administrative proceedings is costly and may divert our technical and management personnel from their normal responsibilities. We may not prevail in any of these suits. An adverse determination of any litigation or defense proceedings could put our patents at risk of being invalidated or interpreted narrowly and could put our patent applications at risk of not being issued.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could have an adverse effect on the trading price of our Class B common stock.

**Our quarterly results of operations might fluctuate due to seasonality, which could adversely affect our growth rate and in turn the market price of our securities.**

Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in the level of mobile and Internet usage and seasonal purchasing cycles of many advertisers. Our experience has shown that during the spring and summer months of the year, mobile and Internet usage is lower than during other times of the year and during the latter part of the fourth quarter of the calendar year we generally experience lower call volume and reduced demand for calls from our mobile call advertising customers. The

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extent to which usage and call volume may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage and call volume during these periods may adversely affect our growth rate and in turn the market price of our securities. Additionally, the current business environment has resulted in many advertisers and reseller partners reducing advertising and marketing services budgets or changing such budgets throughout the year, which may impact our quarterly results of operations in addition to typical seasonality seen in our industry.

### **We are susceptible to general economic conditions, and a downturn in advertising and marketing spending by advertisers could adversely affect our operating results.**

Our operating results will be subject to fluctuations based on general economic conditions, in particular those conditions that impact advertiser-consumer transactions. Deterioration in economic conditions could cause decreases in or delays in advertising spending and reduce and/or negatively impact our short term ability to grow our revenues. Further, any decreased collectability of accounts receivable or early termination of agreements due to deterioration in economic conditions could negatively impact our results of operations.

### **We depend on the growth of the Internet and mobile and Internet infrastructure for our future growth and any decrease in growth or anticipated growth in mobile and Internet usage could adversely affect our business prospects.**

Our future revenue and profits, if any, depend upon the continued widespread use of the Internet as an effective commercial and business medium. Factors which could reduce the widespread use of the Internet include:

possible disruptions or other damage to the mobile, Internet or telecommunications infrastructure and networks;

failure of the individual networking infrastructures of our advertisers, reseller partners, and distribution partners to alleviate potential overloading and delayed response times;

a decision by advertisers and consumers to spend more of their marketing dollars on offline programs;

increased governmental regulation and taxation; and

actual or perceived lack of security or privacy protection.

In particular, concerns over the security of transactions conducted on the Internet and the privacy of users, including the risk of identity theft, may inhibit the growth of Internet usage, especially mobile and online commercial transactions. In order for the mobile and online commerce market to develop successfully, we and other market participants must be able to transmit confidential information, including credit card information, securely over public networks. Any decrease in anticipated Internet growth and usage could have a material adverse effect on our business prospects.

### **We are exposed to risks associated with credit card fraud and credit payment, and we may continue to suffer losses as a result of fraudulent data or payment failure by advertisers.**

We have suffered losses and may continue to suffer losses as a result of payments made with fraudulent credit card data. Our failure to control fraudulent credit card transactions could reduce our net revenue and gross margin and negatively impact our standing with applicable credit card authorization agencies. In addition, under limited circumstances, we extend credit to advertisers who may default on their accounts payable to us or fraudulently charge-back amounts on their credit cards for services that have already been delivered by us.

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**Government regulation of the Internet may adversely affect our business and operating results.**

Mobile and online search, e-commerce and related businesses face uncertainty related to future government regulation of the Internet through the application of new or existing federal, state and international laws. Due to the rapid growth and widespread use of the Internet, legislatures at the federal and state level have enacted and may continue to enact various laws and regulations relating to the Internet. Individual states may also enact consumer protection laws that are more restrictive than the ones that already exist.

Furthermore, the application of existing laws and regulations to Internet companies remains somewhat unclear. For example, as a result of the actions of advertisers in our network, we may be subject to existing laws and regulations relating to a wide variety of issues such as consumer privacy, gambling, sweepstakes, advertising, promotions, defamation, pricing, taxation, financial market regulation, quality of products and services, computer trespass, spyware, adware, child protection and intellectual property ownership and infringement. In addition, it is not clear whether existing laws that require licenses or permits for certain of our advertisers' lines of business apply to us, including those related to insurance and securities brokerage, law offices and pharmacies. Existing federal and state laws that may impact the growth and profitability of our business include, among others:

The Digital Millennium Copyright Act (DMCA) provides protection from copyright liability for online service providers that list or link to third party web sites. We currently qualify for the safe harbor under the DMCA; however, if it were determined that we did not meet the safe harbor requirements, we could be exposed to copyright infringement litigation, which could be costly and time-consuming.

The Children's Online Privacy Protection Act (COPPA) restricts the distribution online collection of personal information about children and the use of that information. The Federal Trade Commission (FTC) has the authority to impose fines and penalties upon web site operators and online service providers that do not comply with the law's requirements. We do not currently offer any web sites or online services directed to children, nor do we knowingly collect personal data from children.

The Protection of Children from Sexual Predators Act requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.

The Controlling the Assault of Non-Solicited Pornography and Marketing (CAN SPAM) Act of 2003 establishes requirements for those who send commercial e-mails, spells out penalties for entities that transmit noncompliant commercial e-mail and/or whose products are advertised in noncompliant commercial e-mail and gives consumers the right to opt-out of receiving commercial e-mails. The majority of the states also have adopted similar statutes governing the transmission of commercial e-mail. The FTC and the states, as applicable, are authorized to enforce the CAN-SPAM Act and the state-specific statutes, respectively. CAN-SPAM gives the Department of Justice the authority to enforce its criminal sanctions. Other federal and state agencies can enforce the law against organizations under their jurisdiction, and companies that provide Internet access may sue violators as well.

The Electronic Communications Privacy Act prevents private entities from disclosing Internet subscriber records and the contents of electronic communications, subject to certain exceptions.

The Computer Fraud and Abuse Act and other federal and state laws protect computer users from unauthorized computer access/hacking, and other actions by third parties which may be viewed as a violation of privacy. Courts may apply each of these laws in unintended and unexpected ways. As a company that provides services over the Internet as well as call recording and call tracking services, we may be subject to an action brought under any of these or future laws.

Among the types of legislation currently being considered at the federal and state levels are consumer laws regulating for the use of certain types of software applications or downloads and the use of cookies. These proposed laws are intended to target specific types of software applications often referred to as spyware, invasiveware or adware, and may also cover certain applications currently used

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in the online advertising industry to serve and distribute advertisements. In addition, the FTC has sought inquiry regarding the implementation of a do-not-track requirement. Federal legislation is also

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expected to be introduced that would regulate online behavioral advertising practices. If passed, these laws would impose new obligations for companies that use such software applications or technologies.

Many Internet services are automated, and companies such as ours may be unknowing conduits for illegal or prohibited materials. It is possible that some courts may impose a strict liability standard or require such companies to monitor their customers' conduct. Although we would not be responsible or involved in any way in such illegal conduct, it is possible that we would somehow be held responsible for the actions of our advertisers or distribution partners.

We may also be subject to costs and liabilities with respect to privacy issues. Several companies have incurred penalties for failing to abide by the representations made in their public-facing privacy policies. In addition, several states have passed laws that require businesses to implement and maintain reasonable security procedures and practices to protect sensitive personal information and to provide notice to consumers in the event of a security breach. Further, it is anticipated that additional federal and state privacy-related legislation will be enacted. Such legislation could negatively affect our business.

In addition, foreign governments may pass laws which could negatively impact our business and/or may prosecute us for violating existing laws. Such laws might include EU member country conforming legislation under applicable EU Privacy, eCommerce, Telecommunications and Data Protection Directives. Any costs incurred in addressing foreign laws could negatively affect the viability of our business. Our exposure to this risk will increase to the extent we expand our operations internationally.

### **Federal and state regulation of telecommunications may adversely affect our business and operating results.**

Subsidiaries of the Company provide information and analytics services to certain advertisers and reseller partners that may include information services. In connection therewith, the Company, through its subsidiaries, obtains certain telecommunications products and services from carriers in order to deliver these packages of information and analytic services.

Telecommunications laws and regulations (and interpretations thereof) are evolving in response to rapid changes in the telecommunications industry. If our carrier partners were to be subject to any changes in applicable law or regulation (or interpretations thereof), or additional taxes or surcharges, then we in turn may be subject to increased costs for their products and services or receive products and services that may be of less value to our customers, which in turn could adversely affect our business and operating results. Furthermore, to the extent we offer call recording and pay-for-call services, we may be directly subject to certain telecommunications-related regulations. Finally, in the event that any federal or state regulators were to expand the scope of applicable laws and regulations or their application to include certain end users and information service providers, then our business and operating results could also be adversely affected. The following existing and possible future federal and state laws could impact the growth and profitability of our business:

The Communications Act of 1934, as amended by the Telecommunications Act of 1996 (the Act), and the regulations promulgated by the Federal Communications Commission under Title II of the Act, may impose federal licensing, reporting and other regulatory obligations on the Company. To the extent we contract with and use the networks of voice over IP service providers, new legislation or FCC regulation in this area could restrict our business, prevent us from offering service or increase our cost of doing business. There are an increasing number of regulations and rulings that specifically address access to commerce and communications services on the Internet, including IP telephony. We are unable to predict the impact, if any, that future legislation, legal decisions or regulations concerning voice services offered via the Internet may have on our business, financial condition, and results of operations.

The U.S. Congress, the FCC, state legislatures or state agencies may target, among other things, access or settlement charges, imposing taxes related to Internet communications, imposing tariffs or other

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regulations based on encryption concerns, or the characteristics and quality of products and services that we may offer. Any new laws or regulations concerning these or other areas of our business could restrict our growth or increase our cost of doing business.

The FCC has initiated a proceeding regarding the regulation of broadband services. The increasing growth of the broadband IP telephony market and popularity of broadband IP telephony products and services heighten the risk that the FCC or other legislative bodies will seek to regulate broadband IP telephony and the Internet. In addition, large, established telecommunication companies may devote substantial lobbying efforts to influence the regulation of the broadband IP telephony market, which may be contrary to our interests.

There is risk that a regulatory agency will require us to conform to rules that are unsuitable for IP communications technologies or rules that cannot be complied with due to the nature and efficiencies of IP routing, or are unnecessary or unreasonable in light of the manner in which we offer voice-related services such as call recording and pay-for-call services to our customers.

Federal and state telemarketing laws including the Telephone Consumer Protection Act, the Telemarketing Sales Rule, the Telemarketing Consumer Fraud and Abuse Prevention Act and the rules and regulations promulgated thereunder.

Laws affecting telephone call recording and data protection, such as consent and personal data statutes. Under the federal Wiretap Act, at least one party taking part in a call must be notified if the call is being recorded. Under this law, and most state laws, there is nothing illegal about one of the parties to a telephone call recording the conversation. However, several states (i.e., California, Connecticut, Florida, Illinois, Maryland, Massachusetts, Michigan, Montana, Nevada, New Hampshire, Pennsylvania and Washington) require that all parties consent when one party wants to record a telephone conversation. The telephone recording laws in other states, like federal law, require only one party to be aware of the recording. A Wiretap Act violation is a Class D felony; the maximum authorized penalties for a violation of section 2511(1) of the Wiretap Act are imprisonment of not more than five years and a fine under Title 18. Authorized fines are typically not more than \$250,000 for individuals or \$500,000 for an organization, unless there is a substantial loss. State laws impose similar penalties.

The Communications Assistance for Law Enforcement Act may require that the Company undertake material modifications to its platforms and processes to permit wiretapping and other access for law enforcement personnel.

Under various Orders of the Federal Communications Commission, the Company may be required to make material retroactive and prospective contributions to funds intended to support Universal Service, Telecommunications Relay Service, Local Number Portability, the North American Numbering Plan and the budget of the Federal Communications Commission.

Laws in most states of the United States of America may require registration or licensing of one or more subsidiaries of the Company, and may impose additional taxes, fees or telecommunications surcharges on the provision of the Company's services which the Company may not be able to pass through to customers.

**State and local governments may in the future be permitted to levy additional taxes on Internet access and electronic commerce transactions, which could result in a decrease in the level of usage of our services. In addition, we may be required to pay additional income, sales, or other taxes.**

On November 19, 2004, the federal government passed legislation placing a ban on state and local governments' imposition of new taxes on Internet access or electronic commerce transactions which expires in November 2014. Unless the ban is further extended, state and local governments may begin to levy additional taxes on Internet access and electronic commerce transactions upon the legislation's expiration. An increase in taxes may make electronic commerce transactions less attractive for advertisers and businesses, which could result in a decrease in the level of usage of our services. Additionally, from time to time, various state, federal





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and other jurisdictional tax authorities undertake reviews of the Company and the Company's filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for probable exposures. We cannot predict the outcome of any of these reviews.

### **Risks Relating to Ownership of our Common Stock**

#### **Our Class B common stock prices have been and are likely to continue to be highly volatile.**

The trading prices of our Class B common stock have been and are likely to continue to be highly volatile and subject to wide fluctuations. Since our initial public offering, the closing sale price of our Class B common stock on the NASDAQ Global Select Market ranged from \$3.00 to \$26.14 per share through December 31, 2012. Our stock prices may fluctuate in response to a number of events and factors, which may be the result of our business strategy or events beyond our control, including:

developments concerning proprietary rights, including patents, by us or a competitor;

announcements by us or our competitors of significant contracts, acquisitions, financings, commercial relationships, joint ventures or capital commitments;

registration of additional shares of Class B common stock in connection with acquisitions;

actual or anticipated fluctuations in our operating results;

lawsuits initiated against us or lawsuits initiated by us;

announcements of acquisitions or technical innovations;

potential loss or reduced contributions from distribution partners, reseller partners and agencies, or advertisers;

changes in growth or earnings estimates or recommendations by analysts;

changes in the market valuations of similar companies;

changes in our industry and the overall economic environment;

volume of shares of Class B common stock available for public sale, including upon conversion of Class A common stock or upon exercise of stock options;

Class B common stock repurchases under our previously announced share repurchase program;

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sales and purchases of stock by us or by our stockholders, including sales by certain of our executive officers and directors pursuant to written pre-determined selling and purchase plans under Rule 10b5-1 of the Securities Exchange Act of 1934; and

short sales, hedging and other derivative transactions on shares of our Class B common stock.

In addition, the stock market in general, and the NASDAQ Global Select Market and the market for mobile and online commerce companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of the listed companies. These broad market and industry factors may seriously harm the market price of our Class B common stock, regardless of our operating performance. In the past, following periods of volatility in the market, securities class action litigation has often been instituted against these companies.

Litigation against us, whether or not judgment is entered against us, could result in substantial costs and potentially economic loss, and a diversion of our management's attention and resources, any of which could seriously harm our financial condition. Additionally, there can be no assurance that an active trading market of our Class B common stock will be sustained.

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**Our founders control the outcome of stockholder voting, and there may be an adverse effect on the price of our Class B common stock due to the disparate voting rights of our Class A common stock and our Class B common stock.**

As of December 31, 2012, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founders, beneficially owned 100% of the outstanding shares of our Class A common stock, which shares represented 90% of the combined voting power of all outstanding shares of our capital stock. These founders together control 90% of the combined voting power of all outstanding shares of our capital stock. The holders of our Class A common stock and Class B common stock have identical rights except that the holders of our Class B common stock are entitled to one vote per share, while holders of our Class A common stock are entitled to twenty-five votes per share on all matters to be voted on by stockholders. This concentration of control could be disadvantageous to our other stockholders with interests different from those of these founders. This difference in the voting rights of our Class A common stock and Class B common stock could adversely affect the price of our Class B common stock to the extent that investors or any potential future purchaser of our shares of Class B common stock give greater value to the superior voting rights of our Class A common stock. Further, as long as these founders have a controlling interest, they will continue to be able to elect all or a majority of our board of directors and generally be able to determine the outcome of all corporate actions requiring stockholder approval. As a result, these founders will be in a position to continue to control all fundamental matters affecting our company, including any merger involving, sale of substantially all of the assets of, or change in control of, our company. The ability of these founders to control our company may result in our Class B common stock trading at a price lower than the price at which such stock would trade if these founders did not have a controlling interest in us. This control may deter or prevent a third party from acquiring us which could adversely affect the market price of our Class B common stock.

**Anti-takeover provisions may limit the ability of another party to acquire us, which could cause our stock price to decline.**

Our certificate of incorporation, as amended, our by-laws and Delaware law contain provisions that could discourage, delay or prevent a third party from acquiring us, even if doing so may be beneficial to our stockholders. In addition, these provisions could limit the price investors would be willing to pay in the future for shares of our Class B common stock. The following are examples of such provisions in our certificate of incorporation, as amended, or our by-laws:

the authorized number of our directors can be changed only by a resolution of our board of directors;

advance notice is required for proposals that can be acted upon at stockholder meetings;

there are limitations on who may call stockholder meetings; and

our board of directors is authorized, without prior stockholder approval, to create and issue blank check preferred stock.

We are also subject to Section 203 of the Delaware General Corporation Law, which provides, subject to enumerated exceptions, that if a person acquires 15% or more of our voting stock, the person is an interested stockholder and may not engage in business combinations with us for a period of three years from the time the person acquired 15% or more of our voting stock. The application of Section 203 of the Delaware General Corporation Law could have the effect of delaying or preventing a change of control of our company.

**We may not be able to continue to pay dividends on our common stock in the future which could impair the value of such stock.**

Under Delaware law, dividends to stockholders may be made only from the surplus of a company, or, in certain situations, from the net profits for the current fiscal year or the fiscal year before which the dividend is declared. We have initiated and paid a quarterly dividend on our common stock since November 2006. We

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accelerated and paid all four of our 2013 quarterly cash dividends on December 31, 2012. However, there is no assurance that we will be able to pay dividends in the future. Our ability to pay dividends in the future will depend on our financial results, liquidity and financial condition.

Upon completion of the Proposed Spin-off Transaction, the quarterly dividend payments are anticipated to be transitioned from Marchex to Archeo. There can be no assurances that Archeo will continue to pay dividends at such rate or at all.

**ITEM 1B. UNRESOLVED STAFF COMMENTS.**

None.

**ITEM 2. PROPERTIES.**

Our headquarters are located in Seattle, Washington and consist of approximately 61,000 square feet of leased office space expiring in March 2018. We also lease additional office space in Las Vegas, Nevada, and New York, New York with lease terms expiring between April 2014 and March 2018. Our information technology systems are hosted and maintained in third party facilities under collocation services agreements. See Item 1 of this Annual Report on Form 10-K under the caption Information Technology and Systems.

We believe that our existing facilities, together with additional space we believe we can lease at reasonable market rates, are adequate for our near term business needs.

**ITEM 3. LEGAL PROCEEDINGS.**

We are not a party to any material legal proceedings. From time to time, however, we may be subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of intellectual property rights, and a variety of claims arising in connection with our services.

**ITEM 4. MINE SAFETY DISCLOSURES.**

Not Applicable.

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.****Market Information**

Our Class B common stock has been traded on the NASDAQ Global Select Market under the symbol MCHX since March 31, 2004 when we completed our initial public offering at a price of \$6.50 per share. Prior to that time, there was no public market for our Class B common stock. The following table sets forth, for the periods indicated, the high and low closing sales prices for Marchex's Class B common stock as reported on the NASDAQ Global Select Market:

|                                     | High     | Low     |
|-------------------------------------|----------|---------|
| <b>Year ended December 31, 2011</b> |          |         |
| First Quarter                       | \$ 9.94  | \$ 7.42 |
| Second Quarter                      | \$ 8.99  | \$ 6.54 |
| Third Quarter                       | \$ 10.80 | \$ 7.85 |
| Fourth Quarter                      | \$ 9.14  | \$ 5.67 |
| <b>Year ended December 31, 2012</b> |          |         |
| First Quarter                       | \$ 6.25  | \$ 4.03 |
| Second Quarter                      | \$ 4.47  | \$ 3.19 |
| Third Quarter                       | \$ 4.26  | \$ 3.08 |
| Fourth Quarter                      | \$ 4.46  | \$ 3.64 |

**Holders**

As of March 8, 2013, there were 37,455,606 shares of common stock outstanding that were held by 66 stockholders of record. Of these shares:

9,570,382 shares were issued as Class A common stock, and as of this date were held by 4 stockholders of record; and

28,185,224 shares were issued as Class B common stock, and as of this date were held by 62 stockholders of record.

**Dividends**

In November 2006, we initiated a quarterly cash dividend at \$0.02 per share of Class A common stock and Class B common stock. In August 2012, our board of directors approved an increase to the quarterly cash dividend to Class A and Class B common stockholder from \$0.02 per share to \$0.035 per share. Although we expect that the annual cash dividend, subject to capital availability, will be \$0.14 per common share or approximately \$5.2 million for the foreseeable future, there can be no assurance that we will continue to pay dividends at such rate or at all. In December 2012, our board of directors declared a quarterly dividend for the first, second, third and fourth quarters of 2013 totaling \$0.14 per share on our Class A common stock and Class B common stock which was paid on December 31, 2012 to holders of record as of the close of business on December 18, 2012. The dividend paid totaled approximately \$5.3 million. Upon completion of the proposed separation, the quarterly dividend payments are anticipated to be transitioned from Marchex to Archeo. There can be no assurances that Archeo will continue to pay dividends at such rate or at all.

**Table of Contents****Issuer Purchases of Equity Securities**

During the fourth quarter of 2012, share repurchase activity was as follows:

| <b>Period</b>                                      | <b>Total number of shares purchased</b> | <b>Average price paid per share</b> | <b>Total number of shares purchased as part of publicly announced plans or programs</b> | <b>Maximum number of shares (or approximate dollar value) that may yet be purchased under the plans or programs<sup>(1)</sup></b> |
|--|---|-------------------------------------|---|---|
| <b>Class B Common Shares:</b>                      |   |                                     |   |   |
| October 1 - October 31, 2012 <sup>(2)</sup>        | 22,264                                  | \$ 1.87                             | 10,764  | 1,760,022   |
| November 1 - November 30, 2012 <sup>(2), (3)</sup> | 199,952                                 | \$ 0.19                             | 9,100   | 1,750,922   |
| December 1 - December 31, 2012 <sup>(2), (3)</sup> | 18,402                                  | \$ 0.51                             | 2,300   | 1,748,622   |
| <b>Total Class B Common Shares</b>                 | <b>240,618</b>                          | <b>\$ 0.37</b>                      | <b>22,164</b>   | <b>1,748,622</b>  |

<sup>(1)</sup> We have established a share repurchase program which authorizes the Company to repurchase up to 13 million shares in the aggregate (less shares previously repurchased under the share repurchase program) of the Company's Class B common stock. No shares will be knowingly purchased from company insiders or their affiliates. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This stock repurchase program does not have an expiration date and may be expanded, limited or terminated at any time without prior notice.

<sup>(2)</sup> Includes 11,500, 190,852 and 16,102 shares of restricted equity subject to vesting for the periods ending October 31, 2012, November 30, 2012 and December 31, 2012, respectively, which were issued to a certain employees. We repurchased shares which were not already vested for \$0.01 share upon termination of employment.

<sup>(3)</sup> Includes 11,109 and 372,923 shares of the Company's Class B common stock for the periods November 30, 2012 and December 31, 2012, respectively, which were repurchased to satisfy the employees' minimum tax withholding obligations in connection with the vesting of restricted stock awards and was based on the fair market value on the vesting date.

**Table of Contents****Stock Performance Graph**

This performance graph shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act) or otherwise subject to the liabilities under that Section and shall not be deemed to be incorporated by reference into any filing of Marchex under the Securities Act of 1933, as amended or the Exchange Act.

The following graph shows a comparison from December 31, 2007 through December 31, 2012 of cumulative total return for our Class B common stock, the NASDAQ Composite Index (the NASDAQ Composite Index) and the RDG Internet Composite Index (the RDG Index). Measurement points are the last trading day of each of the Company's fiscal years ended December 31, 2007 through 2012. The graph assumes that \$100 was invested on December 31, 2007 in the Class B common stock of the Company, the NASDAQ Composite Index and the RDG Internet Composite Index and assumes reinvestment of any dividends. Such returns are based on historical results and are not intended to suggest future performance.

\*\$100 invested on 12/31/07 in stock or index, including reinvestment of dividends.

Fiscal year ending December 31.

|                              | 12/31/07  | 12/31/08 | 12/31/09 | 12/31/10  | 12/31/11  | 12/31/12  |
|------------------------------|-----------|----------|----------|-----------|-----------|-----------|
| Marchex, Inc.                | \$ 100.00 | \$ 54.16 | \$ 48.03 | \$ 91.53  | \$ 60.55  | \$ 42.34  |
| NASDAQ Composite Index       | \$ 100.00 | \$ 59.03 | \$ 82.25 | \$ 97.32  | \$ 98.63  | \$ 110.78 |
| RDG Internet Composite Index | \$ 100.00 | \$ 56.53 | \$ 98.33 | \$ 110.81 | \$ 114.60 | \$ 136.20 |

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA.**

The following selected consolidated financial data should be read in conjunction with Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the related notes appearing elsewhere in this Form 10-K.

The consolidated financial data for the years ended December 31, 2008 and 2009 is derived from our audited consolidated financial statements which are not included in this Form 10-K.

The consolidated statement of operations data for the years ended December 31, 2010, 2011 and 2012, and the consolidated balance sheet data at December 31, 2011 and 2012, are derived from our audited consolidated financial statements appearing elsewhere in this Form 10-K.

The historical results are not necessarily indicative of the results to be expected in any future period.

**Consolidated Statements of Operations Data (in thousands except per share amounts):**

|  | Year ended December 31, |            |            |            |             |
|--|-------------------------|------------|------------|------------|-------------|
|  | 2008                    | 2009       | 2010       | 2011       | 2012        |
| Revenue  | \$ 146,375              | \$ 93,261  | \$ 97,566  | \$ 146,726 | \$ 138,305  |
| Income (loss) from operations  | \$ (175,286)            | \$ (3,570) | \$ (3,789) | \$ 6,030   | \$ (18,190) |
| Net income (loss)  | \$ (127,864)            | \$ (2,062) | \$ (3,043) | \$ 2,959   | \$ (35,196) |
| Net income (loss) applicable to common stockholders  | \$ (128,132)            | \$ (2,249) | \$ (3,242) | \$ 2,700   | \$ (35,853) |
| Basic and diluted net income (loss) per share applicable to Class A stockholders               | \$ (3.52)               | \$ (0.07)  | \$ (0.10)  | \$ 0.08    | \$ (1.06)   |
| Basic and diluted net income (loss) per share applicable to Class B common stockholders        | \$ (3.52)               | \$ (0.07)  | \$ (0.10)  | \$ 0.08    | \$ (1.05)   |
| Shares used to calculate basic net income (loss) per share applicable to common stockholders   |                         |            |            |            |             |
| Class A  | 10,964                  | 10,884     | 10,661     | 9,928      | 9,574       |
| Class B  | 25,468                  | 22,830     | 21,993     | 23,358     | 24,412      |
| Shares used to calculate diluted net income (loss) per share applicable to common stockholders |                         |            |            |            |             |
| Class A  | 10,964                  | 10,884     | 10,661     | 9,928      | 9,574       |
| Class B  | 36,432                  | 33,714     | 32,654     | 35,318     | 33,986      |

**Consolidated Balance Sheet Data (in thousands):**

|  | December 31, |            |            |            |            |
|--|--------------|------------|------------|------------|------------|
|  | 2008         | 2009       | 2010       | 2011       | 2012       |
| Cash and cash equivalents                | \$ 27,418    | \$ 33,638  | \$ 37,328  | \$ 37,443  | \$ 15,930  |
| Working capital                          | \$ 34,988    | \$ 41,273  | \$ 47,305  | \$ 16,168  | \$ 21,683  |
| Total assets                             | \$ 170,270   | \$ 159,373 | \$ 159,690 | \$ 220,058 | \$ 149,147 |
| Other non-current liabilities            | \$ 23        | \$ 1,005   | \$ 2,076   | \$ 2,580   | \$ 2,216   |
| Total liabilities                        | \$ 20,962    | \$ 17,948  | \$ 19,998  | \$ 61,050  | \$ 26,212  |
| Total stockholders' equity               | \$ 149,308   | \$ 141,425 | \$ 139,692 | \$ 159,008 | \$ 122,935 |
| Cash dividends declared per common share | \$ 0.08      | \$ 0.08    | \$ 0.08    | \$ 0.08    | \$ 0.25    |



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**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

*The following discussion should be read in conjunction with the audited consolidated financial statements and the notes to those statements which appear elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements. Please see page 1 on this Annual Report on Form 10-K Forward-Looking Statements and Item 1A of this Annual Report on Form 10-K under the caption Risk Factors for a discussion of the risks, uncertainties and assumptions associated with these statements.*

**Overview**

We are a mobile performance company that delivers consumer calls to businesses and analyzes those calls. We also provide performance-based online advertising that connects advertisers with consumers across our owned web sites as well as third party web sites.

Our technology-based products and services facilitate the efficient and cost-effective marketing and selling of goods and services for small and national advertisers who want to market and sell their products through mobile, online and offline; and a proprietary, locally-focused web site network where we help consumers find local information, as well as fulfill our advertiser marketing campaigns. Our primary products are as follows:

***Digital Call Advertising Services.*** Through our Digital Call Marketplace, we deliver a variety of digital call advertising products and services to national advertisers, advertising agencies and small advertiser reseller partners. These services include providing targeted pay-for-call advertisements through the Marchex Digital Call Marketplace, and Marchex Call Analytics, one of the largest sources of call-ready media in North America. It offers exclusive and preferred ad placements across numerous mobile and online media sources, so advertisers can drive qualified calls to their businesses. It leverages our Call Analytics platform to secure call tracking numbers and to provide qualified calls to advertisers that block spam and other telemarketing calls while working to optimize the return on investment for advertisers' marketing investment.

***Call Analytics.*** Our Call Analytics (technology platform) provides data and insights that measure the performance of mobile, online and offline advertising for advertisers and small business resellers. It includes phone numbers, call tracking, recording, call mining, real-time intelligence and several other insights to help advertisers make more informed campaign optimization decisions to drive quality customer calls from their advertising and measure their return on investment across all media channels. Advertisers pay us a fee for each call they receive from call-based ads we distribute through our sources of call distribution or for each phone number tracked based on a pre-negotiated rate.

***Local Leads.*** Our Local Leads platform, is a white-labeled, full service digital advertising solution for small business resellers, such as Yellow Pages providers and vertical marketing service providers, to sell digital call advertising and/or search marketing and other lead products through their existing sales channels to their small business advertisers. These calls and leads are then fulfilled by us across our distribution network, including mobile sources, and leading search engines. By creating a solution for companies who have relationships with small businesses, it is easier for these small businesses to participate in mobile, online, and offline call advertising. The lead services we offer to small business advertisers through our Local Leads platform include products typically available only to national advertisers, including pay-for-call, call tracking, presence management ad creation, keyword selection, geo-targeting, advertising campaign management, reporting, and analytics. The Local Leads platform has the capacity to support hundreds of thousands of advertiser accounts. Reseller partners and publishers generally pay us account fees and agency fees for our products in the form of a percentage of the cost of every click or call delivered to their advertisers. Through our contract with Yellowpages.com LLC d/b/a AT&T Interactive which is a subsidiary of AT&T (collectively, "AT&T"), our arrangement with AT&T relates to a business unit that is included in a newly formed unit called YP Holdings, LLC

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( YP ) that AT&T sold a majority stake in to a private equity third party in 2012. YP is our largest reseller partner and was responsible for 27% of our total revenues for 2012 of which the majority is derived from our local leads platform.

***Pay-Per-Click Advertising.*** We deliver pay-per-click advertisements to online users in response to their keyword search queries or on pages they visit throughout our distribution network of search engines, shopping engines, certain third party vertical and local web sites, mobile distribution and our own proprietary web site traffic sources. In addition to distributing their ads, we offer account management services to help our advertisers optimize their pay-per-click campaigns, including editorial and keyword selection recommendations and report analysis, as well as presence management services. The pay-per-click advertisements are generally ordered based on the amount our advertisers choose to pay for a placement and the relevancy of their ads to the keyword search. Advertisers pay us when a user clicks on their advertisements in our distribution network and we pay publishers or distribution partners a percentage of the revenue generated by the click-throughs on their site(s). In addition, we generate revenue from cost-per-action events that take place on our distribution network. Cost-per-action revenue occurs when the user is redirected from one of our web sites or a third party web site in our distribution network to an advertiser's web site and completes a specified action. We also offer a private-label platform for publishers, which enable them to monetize their web sites with contextual advertising from their own customers or from our advertising relationships. We sell pay-per-click contextual advertising placements on specialized vertical and branded publisher web sites on a pay-per-click basis. Advertisers can target the placements by vertical, site or on a page-specific basis. We believe our site and page-specific approach provides publishers with an opportunity to generate revenue from their traffic while protecting their brand. Our approach gives advertisers greater transparency into the source of the traffic and relevancy for their ads and enables them to optimize the return on investment from their advertising campaigns. The contextual advertisement placements are generally ordered based on the amount our advertisers choose to pay for a placement and the relevance of the advertisement, based on historic click-through rates. Advertisers pay us when a user clicks on their advertisements in our network and we pay publishers a percentage of the revenue generated by the click-throughs on their site.

***Proprietary Web Site Traffic.*** Our Proprietary Web Site Traffic includes more than 200,000 of our owned and operated web sites focused on helping users make informed decisions about where to get local products and services. The more than 200,000 web sites in our network include more than 75,000 U.S. ZIP code sites, including 98102.com and 90210.com, covering ZIP code areas nationwide, as well as tens of thousands of other locally-focused sites such as Yellow.com, OpenList.com and geo-targeted sites. Traffic to our proprietary web sites is primarily monetized with pay-per-click listings that are relevant to the web sites, as well as other forms of advertising, including impression-based advertising.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date.

We currently have offices in Seattle, Washington; Las Vegas, Nevada; and New York, New York.

***Acquisition***

On April 7, 2011, we acquired 100% of the stock of Jingle Networks, Inc. ( Jingle ) a provider of mobile voice search performance advertising and technology solutions in North America for the following consideration:

Approximately \$15.8 million in cash, net of cash acquired, and 1,019,103 shares of the Company's Class B common stock paid at closing; plus

Future consideration of (i) \$17.6 million, net of certain working capital adjustments on the first anniversary of the closing, and (ii) \$18.0 million on the 18th month anniversary of closing, with the future consideration payable in either cash or shares of the Company's Class B common stock or some combination to be determined by Marchex. Any shares issued in payment of the future consideration

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will be increased by 5%. In April 2012 and October 2012, the Company paid approximately \$16.9 million and \$17.9 million in cash, net of certain working capital and other adjustments, on the first and 18<sup>th</sup> month anniversary of closing, respectively. Following the closing, we issued 462,247 shares of restricted stock at an aggregate value of approximately \$3.3 million to employees of Jingle, subject to vesting for up to four years.

The fair value of the shares of Class B common stock issued as part of the consideration paid was valued at \$7.6 million using the Company's closing stock price of \$7.46 per share at the acquisition date. The fair value of the future consideration payments of \$34.7 million, was determined using a rate of approximately 2% based on the Company's incremental borrowing rate and was recorded as current deferred acquisition payments in the balance sheet in 2011.

### ***Proposed Separation***

On November 1, 2012, Marchex announced that its board of directors has authorized Marchex to pursue the separation of its business into two distinct publicly traded entities. The separation is expected to be a tax-free pro rata distribution in which Marchex's existing stockholders would hold interests in: (1) Marchex, a mobile advertising company focused on calls, and (2) Archeo, a domain and click-based advertising business. Completion of the proposed separation is subject to certain conditions, including final approval by Marchex's board of directors, receipt of regulatory approvals, favorable tax rulings and/or opinions regarding the tax-free nature of the transaction to Marchex and to its stockholders, further due diligence as appropriate, and the filing and effectiveness of appropriate filings with the Securities and Exchange Commission. While Marchex expects to complete the separation during 2013, we cannot assure that the separation will be completed and if completed on the anticipated timeline or that the terms of the separation will not change. Following the separation, Marchex will cease to own any equity interest in Archeo, and Archeo will operate as an independent, publicly-traded company. See Item 1A. Risk Factors for certain risk factors relating to the proposed business separation.

### ***Consolidated Statements of Operations***

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

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

### ***Presentation of Financial Reporting Periods***

The comparative periods presented are for the years ended December 31, 2010, 2011 and 2012.

### ***Revenue***

We currently generate revenue through our digital call advertising services, pay-per-click advertising, local leads platform which include our call and click services, and proprietary web site traffic.

Our primary sources of revenue are the performance-based advertising services, which include digital call advertising, pay-per-click services and cost-per-action services. These primary sources amounted to greater than 79% of our revenues in all periods presented. Our secondary sources of revenue are our local leads platform which enables partner resellers to sell call advertising and/or search marketing products and campaign management services. These secondary sources amounted to less than 21% of our revenues in all periods presented. We have no barter transactions.

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

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

### ***Performance-Based Advertising Services***

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

We generate revenue from reseller partners and publishers utilizing our local leads platform to sell call advertising and/or search marketing products. We are paid account fees and also agency fees for our products in the form of a percentage of the cost of every call or click delivered to advertisers. The reseller partners or publishers engage the advertisers and are the primary obligor, and we, in certain instances, are only financially liable to the publishers in our capacity as a collection agency for the amount collected from the advertisers. We recognize revenue for these fees under the net revenue recognition method. In limited arrangements resellers pay us a fee for fulfilling an advertiser's campaign in our distribution network and we act as the primary obligor. We recognize revenue for these fees under the gross revenue recognition method.

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

### ***Search Marketing Services***

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

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

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

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### ***Industry and Market Factors***

We enter into agreements with various mobile, online and offline distribution partners to provide distribution for pay-for-call and pay-per-click advertisement listings which contain call tracking numbers and/or URL strings of our advertisers. We generally pay distribution partners based on a percentage of revenue or a fixed amount for each phone call or per click-through on these listings. The level of phone calls and click-throughs contributed by our distribution partners has varied, and we expect it will continue to vary, from quarter to quarter and year to year, sometimes significantly. If we do not add new distribution partners, renew our current distribution partner agreements, replace traffic lost from terminated distribution agreements with other sources or if our distribution partners' search businesses do not grow or are adversely affected, our revenue and results of operations may be materially and adversely affected. Our ability to grow will be impacted by our ability to increase our distribution, which impacts the number of mobile and Internet users who have access to our advertisers' listings and the rate at which our advertisers are able to convert calls and clicks from these mobile and Internet users into completed transactions, such as a purchase or sign up. Our ability to grow also depends on our ability to continue to increase the number of advertisers who use our services and the amount these advertisers spend on our services.

We anticipate that these variables will fluctuate in the future, affecting our ability to grow and our financial results. In particular, it is difficult to project the number of phone calls or click-throughs which will be delivered to our advertisers and how much advertisers will spend with us, and it is even more difficult to anticipate the average revenue per phone call or click-through. It is also difficult to anticipate the impact of worldwide economic conditions on advertising budgets, including due to the economic uncertainty resulting from recent disruptions in global financial markets.

In addition, we believe we will experience seasonality. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of mobile and Internet usage and seasonal purchasing cycles of many advertisers. Our experience has shown that during the spring and summer months, mobile and Internet usage is lower than during other times of the year and during the latter part of the fourth quarter of the calendar year we generally experience lower call volume and reduced demand for calls from our mobile call advertising customers. The extent to which usage and call volume may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage and call volume during these periods may adversely affect our growth rate and results. Additionally, the current business environment has generally resulted in advertisers and reseller partners reducing advertising and marketing services budgets or changing such budgets throughout the year, which we expect will impact our quarterly results of operations in addition to the typical seasonality seen in our industry.

### **Service Costs**

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

user acquisition costs;

amortization of intangible assets;

license and content fees;

credit card processing fees;

network operations;

serving our search results;

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telecommunication costs, including the use of phone numbers relating to our call products and services;

maintaining our web sites;

domain name registration renewal fees;

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network fees;

fees paid to outside service providers;

delivering customer service;

depreciation of our web sites, network equipment and internally developed software;

colocation service charges of our network web site equipment;

bandwidth and software license fees;

payroll and related expenses of related personnel; and

stock-based compensation of related personnel.

***User Acquisition Costs***

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

fixed payments, based on a guaranteed minimum amount of usage delivered;

variable payments based on a specified metric, such as number of paid phone calls or click-throughs; and

a combination arrangement with both fixed and variable amounts that may be paid in advance.

We expense user acquisition costs based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments with minimum guaranteed amounts of usage are expensed as the greater of the pro-rata amount over the term of arrangement or the actual usage delivered to date based on the contractual revenue share. Agreements with variable payments based on a percentage of revenue, number of paid phone calls, click-throughs or other metrics are expensed as incurred based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

**Sales and Marketing**

Sales and marketing expenses consist primarily of:

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

advertising and promotional expenditures including online and outside marketing activities;

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

stock-based compensation of related personnel.

**Product Development**

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

Our research and development expenses include:

payroll and related expenses for personnel;

costs of computer hardware and software;



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

stock-based compensation of related personnel.

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

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with FASB ASC 350. This statement requires that costs incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

### **General and Administrative**

General and administrative expenses consist primarily of:

payroll and related expenses for executive and administrative personnel;

professional services, including accounting, legal and insurance;

bad debt provisions;

facilities costs;

other general corporate expenses; and

stock-based compensation of related personnel.

### **Stock-Based Compensation**

We measure stock-based compensation cost at the grant date based on the fair value of the award and recognize it as expense, net of estimated forfeitures, over the vesting or service period, as applicable, of the stock award using the straight-line method. Stock-based compensation expense has been included in the same lines as compensation paid to the same employees in the consolidated statement of operations.

### **Amortization of Intangibles from Acquisitions**

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

The intangible assets have been identified as:

non-competition agreements;

trademarks and Internet domain names;

distributor relationships;

advertising relationships;

patents; and

acquired technology.

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

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### **Provision for Income Taxes**

We utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax law is recognized in results of operations in the period that includes the enactment date.

As of December 31, 2012, we have net deferred tax assets of \$28.5 million, relating to the impairment of goodwill, amortization of intangibles assets, certain other temporary differences, acquired federal and state net operating loss carryforwards, and research and development credits. At December 31, 2011 and 2012, the Company recorded a valuation allowance of \$4.6 million and \$21.6 million, respectively, against its federal, state, city and foreign net deferred tax assets, as it believes it is more likely than not that these benefits will not be realized. The change in the valuation allowance in 2012 was approximately \$17.0 million.

Each reporting period we must assess the likelihood that our deferred tax assets will be recovered from existing deferred tax liabilities or future taxable income, and to the extent that realization is not more likely than not, a valuation allowance must be established. The establishment of a valuation allowance and increases to such an allowance may result in either increases to income tax expense or reduction of income tax benefit in the statement of operations. At the end of the fourth quarter of 2012, we recognized a partial valuation allowance of \$16.4 million on our federal deferred tax assets. In assessing whether it is more likely than not that our deferred tax assets will be realized, factors considered included: historical taxable income, historical trends related to advertiser usage rates, projected revenues and expenses, macroeconomic conditions, issues facing our industry, existing contracts, our ability to project future results and any appreciation of our other assets. During the fourth quarter of 2012, we incurred a \$16.7 million goodwill impairment loss within our Archeo operating segment due in part to lower projected revenue growth rates and profitability levels within Archeo compared to historical results.

The majority of the deferred tax assets have arisen due to deductions taken in the financial statements related to the impairment of goodwill and the amortization of intangible assets recorded in connection with various acquisitions that are tax-deductible over 15 year periods. Consequently, based on projections of future taxable income and tax planning strategies, we expect to be able to recover a portion of these assets. Although realization is not assured, we believe it is more likely than not, based on our operating performance, existing deferred tax liabilities, projections of future taxable income and tax planning strategies, that our net deferred tax assets, excluding certain state and foreign net operating loss carryforwards, will be realized. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if our projections of future taxable income are reduced or if we do not perform at the levels we are projecting. This could result in increases to the valuation allowance for deferred tax assets and a corresponding increase to income tax expense of up to the entire net amount of deferred tax assets.

As of December 31, 2012, based upon both positive and negative evidence available, we have determined it is not more likely than not that certain deferred tax assets primarily relating to net operating loss carryforwards in certain state, city, and foreign jurisdictions will be realizable and accordingly, have recorded a 100% valuation allowance of \$5.2 million against these deferred tax assets. We do not have a history of taxable income in the relevant jurisdictions and the state and foreign net operating loss carryforwards will more likely than not expire unutilized. Should we determine in the future that we will be able to realize these deferred tax assets, or not be able to realize all or part of our remaining net deferred tax assets recorded as of December 31, 2012, an adjustment to the net deferred tax assets would impact net income or stockholders equity in the period such determination was made.

As of December 31, 2011 and 2012, we had certain federal NOL carryforwards of \$1.7 million which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. We believe that such a change has

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occurred, and that approximately \$1.7 million of NOL carryforwards is limited such that substantially all of these federal NOL carryforwards will never be available. Accordingly, we have not recorded a deferred tax asset for these NOL s.

In connection with the Jingle acquisition in 2011, the Company acquired federal NOL carryforwards. Where there is a change in ownership within the meaning of Section 382 of the Internal Revenue Code, the acquired federal net operating loss carryforwards are subject to an annual limitation. The Company believes that such an ownership change had occurred at Jingle, and that the utilization of the carryforwards is limited such that the majority of the NOL carryforwards will never be utilized. Accordingly, the Company has not recorded those amounts the Company believes it will not be able to utilize and has not included those NOL carryforwards in its deferred tax assets. The Company s preliminary estimate of the acquired NOL carryforwards that may be utilized is approximately \$7.0 million. In 2011, the Company utilized approximately \$2.6 million.

From time to time, various state, federal, and other jurisdictional tax authorities undertake reviews of us and our filings. We believe any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

**Comparison of the year ended December 31, 2011 (2011) to the year ended December 31, 2012 (2012) and comparison of the year ended December 31, 2010 (2010) to the year ended December 31, 2011 (2011).**

**Segments**

During the fourth quarter of 2012, we announced our intention to pursue a spin-off of Archeo and the corresponding organizational changes, resulted in a change to our reportable operating segments. The new reporting disaggregates our operations into: (1) the Call-driven segment which is comprised of our performance-based advertising business focused on driving phone calls; and (2) the Archeo segment which is comprised of our click-based advertising and Internet domain name businesses. Prior to the fourth quarter of 2012, the Company operated in a single reportable operating segment.

**Revenue.**

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

|                                      | Years ended December 31, |                   |                   |
|--------------------------------------|--------------------------|-------------------|-------------------|
|                                      | 2010                     | 2011              | 2012              |
| Partner and Other Revenue Sources    | \$ 71,537                | \$ 126,210        | \$ 127,415        |
| Proprietary Web Site Traffic Sources | 26,029                   | 20,516            | 10,890            |
| <b>Total Revenue</b>                 | <b>\$ 97,566</b>         | <b>\$ 146,726</b> | <b>\$ 138,305</b> |

The following table presents our revenues, by operating segments, for the periods presented:

|                      | Years ended December 31, |                   |                   |
|----------------------|--------------------------|-------------------|-------------------|
|                      | 2010                     | 2011              | 2012              |
| Call-driven          | \$ 46,961                | \$ 101,830        | \$ 111,886        |
| Archeo               | 50,605                   | 44,896            | 26,419            |
| <b>Total Revenue</b> | <b>\$ 97,566</b>         | <b>\$ 146,726</b> | <b>\$ 138,305</b> |

**2011 to 2012**

Our partner network revenues are primarily generated using third party distribution networks to deliver the pay-for-call and pay-per-click advertisers listings. The distribution network includes mobile and online search engine applications, directories, destination sites, shopping engines, third party Internet domains or web sites, other targeted Web-based content, mobile carriers, and offline sources. We generate revenue upon delivery of



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qualified and reported phone calls or click-throughs to our advertisers or to advertising services providers listings. We pay a revenue share to the distribution partners to access their mobile, online, offline or other user traffic. Other revenues include our call provisioning and call tracking services, presence management services, campaign management services and outsourced search marketing platforms. Our proprietary web site traffic revenues are generated from our portfolio of owned web sites which are monetized with pay-for-call or pay-per-click listings that are relevant to the web sites, as well as other forms of advertising, including banner advertising. When an online user navigates to one of our web sites and calls or clicks on a particular listing or completes the specified action, we receive a fee.

Revenue decreased 6% from \$146.7 million for 2011 compared to \$138.3 million in 2012. The partner and other revenues increased \$1.2 million due almost entirely to increased revenues from our call advertising services and partially attributable to the April 2011 Jingle acquisition. Our call advertising services revenue increases are primarily due to increase in national advertiser budgets and thousands of additional small business accounts utilizing our call analytics platform. This increase was offset by a \$9.2 million decrease in revenue from our pay-per-click services primarily due to fewer advertisers and lower advertiser spend amounts.

Our proprietary web site traffic revenues decreased \$9.6 million and were primarily due to \$8.0 million in lower revenues for cost-per-actions from resellers related to our local search and directory web sites. The remainder of such decrease was largely due to lower revenues from our arrangement with Google whereby we receive payment upon click-throughs on per-per-click listings presented on our web sites. This decrease was principally due to fewer click-throughs to our web sites. In the near term, we expect modestly lower to similar proprietary web site traffic revenues as a result of modestly lower budgets for cost-per-actions from resellers particularly related to our local search and directory web sites.

Our arrangement with AT&T relates to a business unit that AT&T formed in 2012 called YP Holdings, LLC ( YP ) that AT&T sold a majority stake in to a private equity third party. Under our primary arrangement with YP, we generate revenues from our local leads platform to sell call advertising and /or search marketing packages through their existing sales channels, which are then fulfilled by us across our distribution network. We are paid account fees and also agency fees for our products in the form of a percentage of the cost of every call or click delivered to their advertisers. In the second quarter of 2010, we signed an extension of our arrangement with YP through September 30, 2015 that includes certain exclusivity provisions for new advertiser accounts and migration of several thousand existing advertiser accounts. It is possible the partial divestiture of this business unit by AT&T may result in changes to our relationship and arrangement with YP, including changes that may result in a significant reduction in the paid account fees and agency fees that we receive from YP. There can be no assurance that our business with YP in the future will continue at or near current levels. YP accounted for 23%, 31% and 27% of total revenues during the years ended December 31, 2010, 2011 and 2012, respectively.

**2010 to 2011**

Revenue increased 50% from \$97.6 million for 2010 compared to \$146.7 million in 2011. The partner and other revenues increased \$54.7 million due almost entirely to increased revenues from our call advertising services, which includes approximately \$17.0 million indirectly attributable to the pre-existing customers from the Jingle acquisition, and local leads products which in part was driven by adding tens of thousands of national and small business accounts across our call advertising services and local leads product platforms and certain pricing reductions and incentives provided to YP in 2010. We estimated these incentives in comparison to the prior pricing arrangement likely generated an estimated \$8 million in savings to YP during 2010. This increase was offset by an \$800,000 decrease in revenue from our pay-per-click services.

Our proprietary web site traffic revenues decreased \$5.5 million and were primarily a result of decreased revenues for cost-per-actions from resellers related to our local search and directory web sites.

Our ability to maintain and grow our revenues will depend in part on maintaining and increasing the number of phone calls and click-throughs performed by users of our service through our distribution partners and

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proprietary web site traffic sources and maintaining and increasing the number and volume of transactions and favorable variable payment terms with advertisers and advertising services providers, which we believe is dependent in part on marketing our web sites and delivering high quality traffic that ultimately results in purchases or conversions for our advertisers and advertising services providers. We may increase our direct monetization of our proprietary web site traffic sources which may not be at the same rate levels as other advertising providers and could adversely affect our revenues and results of operations. Companies distributing advertising through the Internet and mobile sources have experienced, and will likely to continue experience, consolidation. If we do not add new distribution partners, renew our current distribution partner agreements or replace traffic lost from terminated distribution agreements with other sources or if our distribution partners' businesses do not grow or are adversely affected or our distribution partners adversely impact market terms of distribution, our revenue and results of operations may be materially and adversely affected. If revenue grows and the volume of transactions and traffic increases, we will need to expand our network infrastructure. Inefficiencies in our network infrastructure to scale and adapt to higher traffic volumes could materially and adversely affect our revenue and results of operations.

We anticipate that these variables will fluctuate in the future, affecting our growth rate and our financial results. In particular, it is difficult to project the number of phone calls and click-throughs we will deliver to our advertisers and how much advertisers will spend with us, and it is even more difficult to anticipate the average revenue per phone call or click-through. It is also difficult to anticipate the impact of worldwide economic conditions on advertising budgets, including due to the economic uncertainty resulting from periodic disruptions in global financial markets.

In addition, we believe we will experience seasonality with our business. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of mobile and Internet usage and seasonal purchasing cycles of many advertisers. Our experience has shown that during the spring and summer months, mobile and Internet usage is generally lower than during other times of the year and during the latter part of the fourth quarter of the calendar year we generally experience lower call volume and reduced demand for calls from our mobile call advertising customers. The extent to which usage and call volume may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage and call volume during these periods may adversely affect our growth rate and results. Additionally, the current business environment has resulted in many advertisers and reseller partners reducing advertising and marketing services budgets or changing such budgets throughout the year, which we expect will impact our quarterly results of operations in addition to the typical seasonality seen in our industry.

**Expenses**

Expenses were as follows (in thousands):

|   | Twelve months ended December 31, |              |            |              |            |              |
|---|----------------------------------|--------------|------------|--------------|------------|--------------|
|   | 2010                             | %<br>revenue | 2011       | %<br>revenue | 2012       | %<br>revenue |
| Service costs                                       | \$ 57,557                        | 59%          | \$ 81,835  | 56%          | \$ 80,594  | 58%          |
| Sales and marketing                                 | 13,530                           | 14%          | 15,434     | 11%          | 13,671     | 10%          |
| Product development                                 | 16,804                           | 17%          | 22,794     | 16%          | 23,395     | 17%          |
| General and administrative                          | 17,507                           | 18%          | 22,709     | 15%          | 22,911     | 17%          |
| Amortization of intangible assets from acquisitions | 2,729                            | 3%           | 5,455      | 4%           | 4,728      | 3%           |
| Acquisition related costs                           |                                  | 0%           | 1,890      | 1%           | 753        | 1%           |
|   | \$ 108,127                       | 111%         | \$ 150,117 | 103%         | \$ 146,052 | 106%         |

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We record stock-based compensation expense under the fair value method. In 2012, we recorded \$15.7 million of stock-based compensation expense as compared to \$15.1 million in 2011 and \$10.8 million in 2010. This stock-based compensation expense has been included in the same lines as compensation paid to the same employees in the consolidated statement of operations.

Stock-based compensation expense was included in the following operating expense categories as follows (in thousands):

|                                       | <b>Twelve months ended December 31,</b> |                  |                  |
|---------------------------------------|---|------------------|------------------|
|                                       | <b>2010</b>                             | <b>2011</b>      | <b>2012</b>      |
| Service costs                         | \$ 805                                  | \$ 1,291         | \$ 1,904         |
| Sales and marketing                   | 799                                     | 1,505            | 2,039            |
| Product development                   | 1,015                                   | 1,416            | 1,051            |
| General and administrative            | 8,213                                   | 10,931           | 10,702           |
| <b>Total stock-based compensation</b> | <b>\$ 10,832</b>                        | <b>\$ 15,143</b> | <b>\$ 15,696</b> |

See Note 6 (b) Stock Option Plan of the consolidated financial statements as well as our Critical Accounting Policies for additional information about stock-based compensation.

*Service Costs.* Service costs decreased 2%, from \$81.8 million in 2011 to \$80.6 million in 2012. The decrease was primarily attributable to a decrease in distribution partner payments, personnel costs, Internet domain amortization, depreciation, facility costs, and fees paid to outside service providers totaling \$3.5 million, partially offset primarily by an increase in communication and network costs and stock-based compensation and to a lesser extent as a result of the April 2011 Jingle acquisition. Service costs, excluding stock-based compensation, related to the Archeo segment decreased 41%, from \$23.8 million in 2011 to \$14.0 million in 2012 primarily due to a decrease in distribution partner payments. Service costs, excluding stock-based compensation, related to the Call-driven segment increased 14%, from \$56.7 million in 2011 to \$64.6 million in 2012 primarily due to increases in distribution partner payments and communication and network costs.

Service costs increased 42%, from \$57.6 million in 2010 to \$81.8 million in 2011. The increase was primarily attributable to an increase in distribution partner payments, fees paid to outside service providers, personnel costs, stock-based compensation, facility costs, communication and network costs, travel, and depreciation totaling \$24.6 million, partially offset primarily by a decrease in Internet domain amortization of \$333,000. These increases are also related to the incremental revenues as a result of the Jingle acquisition and the related operating activities.

Service costs represented 58% of revenue in 2012 compared to 56% in 2011 and 59% in 2010. The 2012 increase as a percentage of revenue in service costs compared to 2011 was primarily a result of our proprietary web site traffic revenues comprising a lower proportion of revenue compared to 2011. Proprietary web site traffic revenues have a lower service cost as a percentage of revenue relative to our overall service cost percentage. The 2011 decrease as a percentage of revenue in service costs compared to 2010 was primarily a result of certain pricing reductions and incentives as part of an extension of our arrangement with AT&T in the second quarter of 2010.

We expect that user acquisition costs and revenue shares to distribution partners are likely to increase prospectively given the competitive landscape for distribution partners. To the extent that payments to pay-for-call, pay-per-click or cost-per-action distribution partners make up a larger percentage of future operations, or the addition or renewal of existing distribution partner agreements are on terms less favorable to us, we expect that service costs will increase as a percentage of revenue. To the extent of revenue declines in these areas, we expect revenue shares to distribution partners to decrease in absolute dollars. Our proprietary web site traffic revenues have a lower service cost as a percentage of revenue relative to our overall service cost percentage. Our proprietary web site traffic revenues have no corresponding distribution partner payments. To the extent our proprietary web site traffic revenues make up a larger percentage of our future operations, we expect that service



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costs will decrease as a percentage of revenue. We expect with an increase in the proportion of partner and other revenue sources and additional investment in our network, service costs will increase as a percentage of revenue in the near term. We also expect that in the longer term service costs will increase in absolute dollars as a result of costs associated with the expansion of our operations and network infrastructure as we scale and adapt to increases in the volume of transactions, calls and traffic and invest in our platforms.

*Sales and Marketing.* Sales and marketing expenses decreased 11% from \$15.4 million in 2011 to \$13.7 million in 2012. As a percentage of revenue, sales and marketing expenses were 11% and 10% for 2011 and 2012, respectively. The net decrease in dollars and percentage of revenue was related primarily to decreases in personnel and online and outside marketing activities totaling \$2.5 million partially offset by an increase in depreciation and stock-based compensation related to the acceleration of certain restricted shares as part of a separation agreement totaling \$892,000. Sales and marketing costs, excluding stock-based compensation, related to the Archeo segment decreased 37% from \$3.9 million to \$2.5 million due primarily to a decrease in online and outside marketing activities. Sales and marketing costs, excluding stock-based compensation, related to the Call-driven segment decreased 8% from \$10.0 million to \$9.2 million due primarily to a decrease in online and outside marketing activities and personnel costs partially offset by an increase in depreciation. We expect some volatility in sales and marketing expenses based on the timing of marketing initiatives but expect sales and marketing expenses in the near term to be relatively stable to modestly higher in absolute dollars. We expect that sales and marketing expenses will increase in connection with any revenue increase to the extent that we also increase our marketing activities and correspondingly could increase as a percentage of revenue.

Sales and marketing expenses increased 14% from \$13.5 million in 2010 to \$15.4 million in 2011. As a percentage of revenue, sales and marketing expenses were 14% and 11% for 2010 and 2011, respectively. The net increase in dollars was related primarily to increases in personnel and stock-based compensation costs related to the Jingle acquisition partially offset by a decrease in online and outside marketing activities. The 2011 decrease as a percentage of revenue in sales and marketing expenses was primarily a result of revenues increasing at a greater rate when compared to the increase in sales and marketing expenses.

*Product Development.* Product development expenses increased 3% from \$22.8 million in 2011 to \$23.4 million in 2012. The increase in dollars was primarily due to an increase in personnel costs, travel costs and depreciation totaling \$936,000 partly related to the April 2011 Jingle acquisition. This increase was partially offset primarily by a decrease in stock-based compensation. As a percentage of revenue, product development expenses were 16% and 17% in 2011 and 2012, respectively. The 2012 increase as a percentage of revenue in product development expense as compared to 2011 was primarily a result of lower revenues with product development remaining relatively stable in absolute dollars. Product development expenses, excluding stock-based compensation, related to the Archeo segment decreased 37% from \$4.0 million to \$2.5 million primarily due to a decrease in personnel costs. Product development expenses, excluding stock-based compensation, related to the Call-driven segment increased 14% from \$17.4 million to \$19.9 million primarily due to an increase in personnel costs.

We expect product development expenditures in the near term to be relatively stable to modestly higher in absolute dollars. In the longer term, we expect that product development expenses will increase in absolute dollars as we increase the number of personnel and consultants to enhance our service offerings and as a result of additional stock-based compensation expense.

Product development expenses increased 36% from \$16.8 million in 2010 to \$22.8 million in 2011. The increase in dollars was primarily due to an increase in personnel costs and stock-based compensation of \$5.0 million partially related to the Jingle acquisition. As a percentage of revenue, product development expenses were 17% and 16% in 2010 and 2011, respectively. The 2011 decrease as a percentage of revenue in product development expense as compared to 2010 was primarily a result of revenues increasing at a greater rate when compared to the increase in product development costs.

*General and Administrative.* General and administrative expenses increased 1%, from \$22.7 million in 2011 to \$22.9 million in 2012. General and administrative expenses remained relatively stable compared to 2011. As a

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percentage of revenue, general and administrative expenses were 15% and 17% in 2011 and 2012, respectively. The 2012 increase as a percentage of revenue in general and administrative expenses was primarily a result of lower revenues with general and administrative expenses remaining relatively stable in absolute dollars. General and administrative expenses, excluding stock-based compensation, related to the Archeo segment decreased 16% from \$1.9 million to \$1.6 million due primarily to a decrease in personnel costs and business taxes which was partially offset by an increase in bad debt. General and administrative expenses, excluding stock-based compensation, related to the Call-driven segment increased 7% from \$9.9 million to \$10.6 million due primarily to an increase in personnel costs. We expect our general and administrative expenses to decrease modestly in the near term as a result of lower stock-based compensation. We expect that our general and administrative expenses will increase in the longer term to the extent that we expand our operations and incur additional costs in connection with being a public company, including expenses related to professional fees and insurance, and as a result of stock-based compensation expense. We also expect fluctuations in our general and administrative expenses to the extent the recognition timing of stock-based compensation is impacted by market conditions relating to our stock price.

General and administrative expenses increased 30%, from \$17.5 million in 2010 to \$22.7 million in 2011. The increase in dollars was primarily due to an increase in personnel costs and stock-based compensation related primarily to the Jingle acquisition. As a percentage of revenue, general and administrative expenses were 18% and 15% in 2010 and 2011, respectively. The 2011 decrease as a percentage of revenue in general and administrative expenses was primarily a result of revenues increasing at a greater rate when compared to the general and administrative expenses.

*Amortization of Intangible Assets from Acquisitions.* Intangible amortization expense decreased from \$5.5 million in 2011 to \$4.7 million in 2012. The decrease was associated with certain intangible assets acquired in the Jingle acquisition in April 2011 and other acquisitions prior to 2011 being fully amortized. During 2012, the amortization of intangibles related to service costs, sales and marketing and general and administrative expenses.

Intangible amortization expense increased from \$2.7 million in 2010 to \$5.5 million in 2011. The increase was associated with amortization of intangible assets acquired in the Jingle acquisition in April 2011 offset partially by certain intangible assets from prior acquisitions being fully amortized. During 2011, the amortization of intangibles related to service costs, sales and marketing and general and administrative expenses.

Our purchase accounting resulted in all assets and liabilities from our acquisitions being recorded at their estimated fair values on their respective acquisition dates. All goodwill, identifiable intangible assets and liabilities resulting from our acquisitions have been recorded in our financial statements. We may acquire identifiable intangible assets as part of future acquisitions, and if so, we expect that our intangible amortization will increase in absolute dollars.

No impairment of our intangible assets, excluding goodwill, have been identified in 2012. The current business environment is subject to evolving market conditions and requires significant management judgment to interpret the potential impact to our assumptions. To the extent that changes in the current business environment impact the Company's ability to achieve levels of forecasted operating results and cash flows, or should other events occur indicating the remaining carrying value of our assets might be impaired, the Company would test its intangible assets for impairment and may recognize an additional impairment loss to the extent that the carrying amount exceeds such asset's fair value.

*Acquisition and separation related costs.* Acquisition and separation related costs of \$753,000 were primarily for professional fees and other procedures associated with our proposed separation of our business into two distinct publicly traded companies partially offset by a \$132,000 benefit recorded in the first quarter of 2012 related to a revision in our original estimates regarding the future obligation related to the Jingle office space. We expect to incur additional separation related costs through the expected separation date.

Acquisition and separation related costs in 2011 of \$1.9 million were primarily for professional fees to perform due diligence, historical audits in connection with regulatory filings and other procedures associated with our acquisition of Jingle in April 2011. Of the \$1.9 million of acquisition related costs, we recognized

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approximately \$372,000 for the future obligations of non-cancelable lease and other costs related to the Jingle office. The portion related to the non-cancelable lease is based on estimates of vacancy period and sublease income. The actual vacancy periods may differ from these estimates, and sublease income, if any, may not materialize. Accordingly, these estimates may be adjusted in future periods.

*Impairment of goodwill.* We perform our annual impairment testing in accordance with the Accounting Standards Codification 350, *Intangibles Goodwill and Other* on November 30. As a result of this testing, we recorded a \$16.7 million non-cash impairment charge on goodwill within the Archeo segment. During the fourth quarter of 2012, we announced our intention to pursue a spin-off of Archeo and the corresponding organizational changes, resulted in a change in to the our reporting units for purposes of assessing potential impairment of goodwill. The estimated fair value of the Archeo reporting unit was based on the estimates of future operating results, discounted cash flows and other market-based factors. The goodwill impairment recorded within the Archeo reporting unit resulted from the newly associated amounts of goodwill allocated upon the commencement of the reporting unit designation in the fourth quarter, and the operating results including lower projected revenue growth rates and profitability levels compared to historical results.

*Gain on sales and disposals of intangible assets, net.* The gain on sales and disposals of intangible assets, net was \$6.3 million in 2012 and was attributable to the sales and disposals of Internet domain names and other intangible assets. The decrease was due to fewer number of domain sales during 2012 compared to the same period in 2011. The gain on sales and disposals of intangible assets, net was \$6.8 million and \$9.4 million in 2010 and 2011, respectively.

*Other income (expense), net.* Other income (expense), net were (\$458,000) and (\$449,000) in 2011 and 2012, respectively. The net decrease in other income (expense), net during 2012 was primarily due to a decrease in accretion of interest expense related to the deferred acquisition consideration for the Jingle acquisition offset by a decrease in other income.

Other income (expense), net were \$129,000 and (\$458,000) in 2010 and 2011, respectively. The net increase in other income (expense), net during 2011 was primarily due to accretion of interest expense related to the future consideration for the Jingle acquisition.

*Income Taxes.* The income tax expense in 2011 was \$2.6 million compared to \$16.6 million in 2012. In 2011, the effective tax rate of 47% differed from the expected effective tax rate of 35% due to state income taxes, non-deductible stock-based compensation related to restricted stock and incentive stock options recorded under the fair-value method, acquisition related costs related to the Jingle acquisition, non-cash accretion of interest expense, and other non-deductible amounts. In 2012, the effective tax rate of (89)% differed from the expected effective tax rate of 34% due primarily to establishment of a partial valuation allowance on our federal deferred tax assets, non-deductible goodwill impairment and other items such as state income taxes, non-deductible stock-based compensation related to restricted stock and incentive stock options recorded under the fair-value method, non-cash accretion of interest expense, and other non-deductible amounts. At the end of the fourth quarter of 2012, we recognized a partial valuation allowance of \$16.4 million on our federal deferred tax assets. In assessing whether it is more likely than not that our deferred tax assets will be realized, factors considered included: historical taxable income, historical trends related to advertiser usage rates, projected revenues and expenses, macroeconomic conditions, issues facing our industry, existing contracts, our ability to project future results and any appreciation of our other assets.

The income tax benefit in 2010 was \$617,000 compared to an income tax expense of \$2.6 million in 2011. In 2010, the effective tax rate benefit of 17% differed from the expected effective tax rate of 35% due to state income taxes, non-deductible stock-based compensation related to restricted stock and incentive stock options recorded under the fair-value method, other non-deductible amounts and an adjustment for the research and experimentation credit for 2010. In addition, we recorded \$362,000 of income tax benefit associated with our federal return audits for years 2005 through 2009. During 2010, 2011 and 2012, we recognized excess tax benefits (shortfalls) on stock option exercises, restricted stock vesting, and dividends paid on unvested restricted stock of approximately (\$537,000), \$913,000, and (\$4.0) million, respectively, which were recorded to additional paid in capital.

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*Net Income (Loss).* Net income decreased from \$3.0 million in 2011 to a net loss of \$35.2 million in 2012. The decrease was primarily attributable to the non-cash charges related to the goodwill impairment and valuation allowance totaling \$33.1 and a decrease in revenues and gain on sales and disposals of intangible assets, net partially offset by a decrease in operating expenses.

Net income (loss) increased from a net loss of \$3.0 million in 2010 to net income of \$3.0 million in 2011. The increase was primarily attributable to an increase in revenues and gains on sales of intangible assets, offset partially by operating costs increases and acquisition related costs of \$1.9 million for 2011 in which there were no comparable costs in 2010. Income tax expense of \$2.6 million recorded in 2011 further offset the increase in revenues. The Jingle acquisition also resulted in increased revenues and operating costs.

**Quarterly Results of Operations (Unaudited)**

The following tables set forth our unaudited quarterly results of operations data for the eight most recent quarters ended December 31, 2012. The information in the tables below should be read in conjunction with our consolidated financial statements and the notes thereto included elsewhere in this report. We have prepared this information on the same basis as the consolidated financial statements and the information includes all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair statement of our financial position and operating results for the quarters or other periods presented. Our quarterly operating results have varied substantially in the past and may vary substantially in the future. You should not draw any conclusions about our future results from the results of operations for any particular quarter or period presented.

| (in thousands)   | Quarter Ended   |                  |                  |                 |                 |                  |                  |                 |
|--|-----------------|------------------|------------------|-----------------|-----------------|------------------|------------------|-----------------|
|  | Mar 31,<br>2011 | June 30,<br>2011 | Sept 30,<br>2011 | Dec 31,<br>2011 | Mar 31,<br>2012 | June 30,<br>2012 | Sept 30,<br>2012 | Dec 31,<br>2012 |
| <b>Consolidated Statement of Operations:</b>                       |                 |                  |                  |                 |                 |                  |                  |                 |
| Revenue  | \$ 29,080       | \$ 38,761        | \$ 39,862        | \$ 39,023       | \$ 35,481       | \$ 34,013        | \$ 34,822        | \$ 33,989       |
| Expenses:  |                 |                  |                  |                 |                 |                  |                  |                 |
| Service costs <sup>(1)</sup>                                       | 16,672          | 21,701           | 21,848           | 21,614          | 19,937          | 19,240           | 20,636           | 20,388          |
| Sales and marketing <sup>(1)</sup>                                 | 2,695           | 3,933            | 4,547            | 4,259           | 3,913           | 4,606            | 2,795            | 2,694           |
| Product development <sup>(1)</sup>                                 | 4,889           | 5,937            | 6,132            | 5,836           | 5,992           | 5,775            | 5,528            | 6,009           |
| General and administrative <sup>(1)</sup>                          | 5,155           | 6,139            | 5,860            | 5,555           | 6,295           | 5,480            | 5,717            | 5,566           |
| Acquisition and separation related costs                           | 402             | 1,049            | 62               | 377             | (132)           |                  | 296              | 589             |
| Amortization of intangible assets from acquisitions <sup>(2)</sup> | 464             | 1,620            | 1,672            | 1,699           | 1,537           | 1,082            | 1,055            | 1,054           |
| Total operating expenses   | 30,277          | 40,379           | 40,121           | 39,340          | 37,542          | 36,183           | 36,027           | 36,300          |
| Impairment of goodwill   |                 |                  |                  |                 |                 |                  |                  | (16,739)        |
| Gain on sales and disposals of intangible assets, net              | 1,913           | 2,712            | 2,487            | 2,309           | 1,463           | 3,258            | 713              | 862             |
| Income (loss) from operations                                      | 716             | 1,094            | 2,228            | 1,992           | (598)           | 1,088            | (492)            | (18,188)        |
| Other income (expense):  |                 |                  |                  |                 |                 |                  |                  |                 |
| Interest income  | 131             | 7                | 3                |                 | 3               | 3                | 3                | 5               |
| Interest and line of credit expense                                | (26)            | (183)            | (198)            | (197)           | (197)           | (111)            | (111)            | (19)            |
| Other  | (3)             | 2                | (1)              | 7               | (3)             | (6)              | (10)             | (6)             |
| Total other income (expense)                                       | 102             | (174)            | (196)            | (190)           | (197)           | (115)            | (118)            | (20)            |
| Income (loss) before provision for income taxes                    | 818             | 920              | 2,032            | 1,802           | (795)           | 973              | (610)            | (18,208)        |
| Income tax expense (benefit)                                       | 242             | 779              | 778              | 814             | (80)            | 577              | (67)             | 16,127          |
| Net income (loss)  | 576             | 141              | 1,254            | 988             | (715)           | 396              | (543)            | (34,335)        |
| Dividends paid to participating securities                         | (63)            | (61)             | (67)             | (68)            | (73)            | (66)             | (123)            | (394)           |
| Net income (loss) applicable to common stockholders                | \$ 513          | \$ 80            | \$ 1,187         | \$ 920          | \$ (788)        | \$ 330           | \$ (666)         | \$ (34,729)     |

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(1) Excludes amortization of intangible assets from acquisitions. Certain reclassifications have been made to prior periods to conform to current period presentation.

(2) Components of amortization of intangible assets from acquisitions:

|                            |        |          |          |          |          |          |          |          |
|----------------------------|--------|----------|----------|----------|----------|----------|----------|----------|
| Service costs              | \$ 464 | \$ 1,314 | \$ 1,359 | \$ 1,378 | \$ 1,216 | \$ 774   | \$ 748   | \$ 747   |
| Sales and marketing        |        | 292      | 298      | 307      | 307      | 307      | 307      | 307      |
| General and administrative |        | 14       | 15       | 14       | 14       | 1        |          |          |
| Total                      | \$ 464 | \$ 1,620 | \$ 1,672 | \$ 1,699 | \$ 1,537 | \$ 1,082 | \$ 1,055 | \$ 1,054 |

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**Liquidity and Capital Resources**

As of December 31, 2011 and 2012, we had cash and cash equivalents of \$37.4 million and \$15.9 million, respectively. As of December 31, 2012, we had current and long term contractual obligations of \$17.4 million and \$11.9 million is for rent under our facility operating leases.

Cash provided by operating activities primarily consists of a net income (loss) adjusted for certain non-cash items such as amortization and depreciation, deferred income taxes, stock-based compensation, excess tax benefit related to stock-based compensation, acquisition related costs, accretion of interest, gain on sale of intangible assets net, impairment of goodwill and changes in working capital.

Cash provided by operating activities for the year ended December 31, 2012 of approximately \$19.9 million consisted primarily of net loss of \$35.2 million adjusted for non-cash items of \$59.2 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and advertiser credits, stock-based compensation, acquisition related costs, accretion of interest, excess tax benefit related to stock-based compensation, deferred income taxes that includes a \$16.4 million valuation allowance, and impairment of goodwill, gain on sales and disposals of intangible and fixed assets, net of \$6.3 million and \$2.2 million provided by working capital and other activities. Included in the working capital amount is \$881,000 of interest accretion paid as part of the 12-month and 18-month deferred acquisition payments made in April and October 2012, respectively.

Cash provided by operating activities for the year ended December 31, 2011 of approximately \$16.8 million consisted primarily of net income of \$3.0 million adjusted for non-cash items of \$27.6 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and advertiser credits, stock-based compensation, acquisition related costs, excess tax benefit related to stock-based compensation, and deferred income taxes, gain on sales and disposals of intangible and fixed assets, net of \$9.4 million and \$4.3 million used for working capital and other activities, which is net of cash received of \$204,000 related to a lease incentive.

With respect to a significant portion of our pay-for call and pay-per-click advertising services, the amount payable to the distribution partners will be calculated at the end of a calendar month, with a payment period following the delivery of the phone calls or click-throughs. These services constituted the majority of revenue in 2010, 2011 and 2012. We generally receive payment from advertisers within several weeks or in close proximity to the corresponding payments to the distribution partners who provide placement for the listings. In certain cases, payments to distribution partners are paid in advance or are fixed in advance based on a guaranteed minimum amount of usage delivered. We have no corresponding payments to distribution partners related to our proprietary web site traffic revenues.

Nearly all of the reseller partner arrangements are billed on a monthly basis following the month of our phone call or click-through delivery. This payment structure results in our advancement of monies to the distribution partners who have provided the corresponding placements of the listings. For these services, reseller partner payments are generally received two to four weeks following payment to the distribution partners. We expect that in the future periods, if the amounts from our reseller partner arrangements account for a greater percentage of our operating activity, working capital requirements will increase as a result.

We have payment arrangements with reseller partners particularly related to our proprietary web site traffic sources or our local leads and call analytics services, such as YP, SuperMedia Inc., hibu (formerly Yellowbook Inc.), The Cobalt Group, and Yellow Media Inc., whereby we receive payment between 30 and 60 days following the delivery of services. For the year and as of December 31, 2012 amounts from these partners totaled 43% of revenue and \$13.3 million in accounts receivable. Based on the timing of payments, we generally have this level of amounts in outstanding accounts receivable at any given time from these partners. There can be no assurances that these partners or other advertisers will not experience further financial difficulty, curtail operations, reduce or eliminate spend budgets, delay payments or otherwise forfeit balances owed. Net accounts receivable balances outstanding at December 31, 2012 from YP totaled \$9.5 million.

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Cash used in investing activities for the year ended December 31, 2012 of approximately \$3.3 million was primarily attributable to purchases for property and equipment of \$2.9 million, which were more than offset by proceeds from the sales of intangible assets of approximately \$6.3 million. Cash used in investing activities for the year ended December 31, 2011 of approximately \$10.4 million was primarily attributable to the cash paid at closing of \$15.8 million related to the Jingle acquisition, and purchases for property and equipment of \$4.0 million, which were partially offset by proceeds from the sales of intangible assets of approximately \$9.5 million. In April 2011, we acquired Jingle in which \$15.8 million, net of cash acquired, was paid at closing. The acquisition includes deferred acquisition payments of \$17.6 million and \$18.0 million to be paid in cash or shares of Class B common stock or a combination of both at the Marchex's option on the 1<sup>st</sup> and 18<sup>th</sup> month anniversaries of closing. The deferred acquisition payments were paid in cash in 2012 and are shown as financing activities. Cash provided by investing activities for the year ended December 31, 2010 of approximately \$3.2 million was primarily attributable to proceeds from the sales of intangible assets of approximately \$6.8 million which were primarily offset by net purchases for property and equipment of \$3.4 million.

We expect property and equipment purchases will increase as we continue to invest in equipment and software. To the extent our operations increase, we expect to increase expenditures for our systems and personnel. We expect our expenditures for product development initiatives and internally developed software will increase in the longer term in absolute dollars as our development activities accelerate and we increase the number of personnel and consultants to enhance our service offerings.

Cash used in financing activities for the year ended December 31, 2012 of approximately \$44.7 million was primarily attributable to the cash payments of the 12-month and 18-month deferred acquisition payments related to the April 2011 Jingle acquisition totaling \$33.9 million, which is net of certain working capital and other adjustment. The deferred acquisition payments excludes the interest accretion of \$881,000 that is shown as an operating cash outflow. Other financing activities include the repurchase of 387,000 shares of Class B common stock for treasury stock totaling approximately \$1.7 million and common stock dividend payments of \$9.4 million, partially offset by net proceeds of approximately \$71,000 from the sale of stock through employee stock options and employee stock plan purchases and \$308,000 from excess tax benefit related to stock-based compensation. The dividend payments in 2012 include the December 2012 board of directors' declaration of quarterly dividends for the first, second, third, and fourth quarters of 2013 totaling \$5.3 million, which was paid on December 31, 2012. Cash used in financing activities for the year ended December 31, 2011 of approximately \$6.3 million was primarily attributable to the repurchase of 883,000 shares of Class B common stock for treasury stock totaling approximately \$6.2 million and common stock dividend payments of \$2.9 million, partially offset by net proceeds of approximately \$1.8 million from the sale of stock through employee stock options and employee stock plan purchases and \$1.0 million from excess tax benefit related to stock-based compensation. Cash used in financing activities for the year ended December 31, 2010 of approximately \$8.9 million was primarily attributable to the repurchase of 1.2 million shares of Class B common stock for treasury stock totaling approximately \$6.5 million and common stock dividend payments of \$2.8 million offset by net proceeds of approximately \$399,000 from the sale of stock through employee stock options and employee stock plan purchases and \$36,000 of excess tax benefits related to stock-based compensation.

The following table summarizes our contractual obligations as of December 31, 2012, and the effect these obligations are expected to have on our liquidity and cash flows in future periods.

| In thousands                                      | Total     | Less than 1<br>year | 1-3 years | 4-5 years | thereafter |
|---|-----------|---------------------|-----------|-----------|------------|
| <b>Contractual Obligations:</b>                   |           |                     |           |           |            |
| Operating leases                                  | \$ 11,924 | \$ 2,235            | \$ 4,513  | \$ 4,599  | \$ 577     |
| Other contractual obligations                     | 5,504     | \$ 2,836            | 2,221     | 447       |            |
| Total contractual obligations <sup>(1), (2)</sup> | \$ 17,428 | \$ 5,071            | \$ 6,734  | \$ 5,046  | \$ 577     |

(1) In February 2005 we entered into a license agreement with an advertising partner which provides for a contingent royalty based on a discounted rate of 3% (3.75% under certain circumstances) of certain of our gross revenues payable on a quarterly basis through December 2016. The royalty payment is recognized as incurred in service costs and is not included in the above schedule.

(2) Our tax contingencies of approximately \$250,000 are not included due to their uncertainty.

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We anticipate that we will need to invest working capital towards the development and expansion of our overall operations. We may also make a significant number of acquisitions, which could result in the reduction of our cash balances or the incurrence of debt. Furthermore, we expect that capital expenditures may increase in future periods, particularly if our operating activity increases.

On November 1, 2012, we announced that our board of directors has authorized the company to pursue the separation of our business into two distinct publicly traded entities. The separation is expected to be a tax-free pro rata distribution in which the Company's existing shareholders would hold interests in: (1) Marchex, a mobile advertising company focused on calls, and (2) Archeo a domain and advertising marketplace. Completion of the proposed separation is subject to certain conditions, including final approval by the Company's board of directors, receipt of regulatory approvals, favorable tax rulings and/or opinions regarding the tax-free nature of the transaction to us and to our shareholder, further due diligence as appropriate, and the filing and effectiveness of appropriate filings with the Securities and Exchange Commission.

On April 1, 2008, we entered into a three year credit agreement which provides us with a \$30 million senior secured revolving credit line, which may be used for various corporate purposes including financing permitted acquisitions, subject to compliance with applicable covenants. During the first quarter of 2011, we signed an amendment to the credit agreement which extended the maturity period through to April 1, 2014 and increases the applicable margin rate by 25 basis points. As of December 31, 2012, we had \$30 million of availability under the credit agreement. We have not yet determined the impact of the proposed separation on our credit agreement.

In November 2006, our board of directors authorized a share repurchase program to repurchase up to 3 million shares of our Class B common stock as well as the initiation of a quarterly cash dividend for the holders of the Class A common stock and Class B common stock. Our board of directors authorized have increases in the share repurchase program to provide for the repurchase of up to 13 million shares in the aggregate (less shares previously purchased under the share repurchase program) of our Class B common stock. Under the share repurchase program, repurchases may take place in the open market and in privately negotiated transactions and at times and in such amounts as we deem appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This share repurchase program does not have an expiration date and may be expanded, limited or terminated at any time without prior notice. During the years ended December 31, 2011 and 2012, approximately 883,000 and 387,000 shares of Class B common stock, respectively, were repurchased under the share purchase program.

The quarterly cash dividend was initiated at \$0.02 per share of Class A common stock and Class B common stock. For 2011, quarterly dividends were paid on February 15, May 16, August 15 and November 15 to Class A and Class B common stockholders of record as of the close of business of February 4, May 6, August 5 and November 5, respectively. Total dividends paid in 2011 were approximately \$2.9 million. For 2012, quarterly dividends were paid on February 15, May 16, August 15, and November 15 to Class A and Class B common stockholders of record as of the close of business of February 4, May 6, August 5 and November 5, respectively and included two additional dividend payments on August 31 and December 31 to holders of record as of the close of business of August 16 and December 18, respectively. In August 2012, the Company's board of directors approved an increase to the Company's quarterly cash dividend on the Company's Class A and Class B common stock, subject to capital availability, from \$0.02 per share to \$0.035 per share. The increase in the dividend raised the annual dividend rate to \$0.14 per share or \$5.3 million. The Company paid the incremental \$0.015 per share dividends totaling \$566,000 on August 31, 2012 to Class A and Class B common stockholders of record as of the close of business on August 16, 2012. In December 2012, the Company's board of directors declared a quarterly dividend for the first, second, third and fourth quarters of 2013 totaling \$0.14 per share on its Class A common stock and Class B common stock, which was paid on December 31, 2012 to the holders of record as of the close of business on December 18, 2012. The dividend paid totaled \$5.3 million. Total dividends paid in 2012 were approximately \$9.4 million.



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Although we expect that the annual cash dividend, subject to capital availability, will be \$0.14 per common share or approximately \$5.3 million for the foreseeable future outside of the 2013 period for which dividends were paid at the end of 2012, there can be no assurance that we will continue to pay dividends at such a rate or at all. Upon completion of the proposed separation, the quarterly dividend payments are anticipated to be transitioned from Marchex to Archeo. There can be no assurances that Archeo will continue to pay dividends at such rate or at all.

Based on our operating plans we believe that our existing credit availability, resources and cash flow provided by ongoing operations, will be sufficient to fund our operations for at least twelve months. Additional equity and debt financing may be needed to support our acquisition strategy, our long-term obligations and our Company's needs. If additional financing is necessary, it may not be available; and if it is available, it may not be possible for us to obtain financing on satisfactory terms. Failure to generate sufficient revenue or raise additional capital could have a material adverse effect on our ability to continue as a going concern and to achieve our intended business objectives. In addition, we anticipate if the proposed separation is consummated, it is likely to have a short term impact on our operating cash flow and additional financing may be necessary.

### **Critical Accounting Policies**

The policies below are critical to our business operations and the understanding of our results of operations. In the ordinary course of business, we make a number of estimates and assumptions relating to the reporting of our results.

Our consolidated financial statements have been prepared using accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses and the related disclosures of contingent assets and liabilities. We base our estimates on historical experience and on various assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our critical accounting policies relate to the following matters and are described below:

Revenue;

Goodwill and intangible assets;

Stock-based compensation;

Allowance for doubtful accounts and advertiser credits; and

Provision for income taxes.

#### ***Revenue***

We currently generate revenue through our operating businesses by delivering call and click-based advertising products that enable advertisers of all sizes to reach consumers across online, mobile and offline sources. Our primary source of revenue is performance-based advertising, which includes pay-for-call advertising, pay-per-click advertising, and cost-per-action services. For pay-for-call and pay-per-click advertising, revenue is recognized upon delivery of qualified and reported phone calls or click-throughs to our advertisers or advertising service providers listing which occurs when an mobile, online or offline user makes a phone call or clicks on any of their advertisements after it has been placed by us or by our distribution partners. Each phone call or click-through on an advertisement listing represents a completed transaction. For cost-per-action services, revenue is recognized when the online user is redirected from one of our web sites or a third party web site in our distribution network to an advertiser web site and completes the specified action. In certain



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

We have entered into agreements with various distribution partners in order to expand our distribution network, which includes mobile and online search engines and applications, directories, shopping engines, third party Internet domains or web sites, other targeted Web-based content, offline sources, and our portfolio of owned web sites, on which we include our advertisers' listings. We generally pay distribution partners based on a specified percentage of revenue or a fixed amount per phone call or click-through on these listings. We act as the primary obligor in these transactions, and we are responsible for providing customer and administrative services to the advertiser. In accordance with FASB ASC 605, the revenue derived from advertisers who receive paid introductions through us as supplied by distribution partners is reported gross based upon the amounts received from the advertiser. We also recognize revenue for certain agency contracts with advertisers under the net revenue recognition method. Under these specific agreements, we purchase listings on behalf of advertisers from search engines and directories. We are paid account fees and also agency fees based on the total amount of the purchase made on behalf of these advertisers. Under these agreements, our advertisers are primarily responsible for choosing the publisher and determining pricing, and the Company, in certain instances, is only financially liable to the publisher for the amount collected from our advertisers. This creates a sequential liability for media purchases made on behalf of advertisers. In certain instances, the web publishers engage the advertisers directly and we are paid an agency fee based on the total amount of the purchase made by the advertiser. In limited arrangements resellers pay us a fee for fulfilling an advertiser's campaign in our distribution network and we act as the primary obligor. We recognize revenue for these fees under the gross revenue recognition method.

We apply FASB ASC 605 to account for revenue arrangements with multiple deliverables. FASB ASC 605 addresses certain aspects of accounting by a vendor for arrangements under which the vendor will perform multiple revenue-generating activities. When an arrangement involves multiple elements, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met. Fair value for each element is established based on the sales price charged when the same element is sold separately.

### ***Goodwill and Intangible Assets***

Goodwill represents the excess of the purchase price over the fair value of identifiable assets acquired and liabilities assumed in business combinations accounted for under the purchase method.

We apply the provisions of FASB ASC 350 *Goodwill and Intangible Assets* acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of FASB ASC 350. FASB ASC 350 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with FASB ASC 360.

Goodwill is tested annually for impairment and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. The provisions of the accounting standard for goodwill and other intangible assets allow us to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Events and circumstances considered in determining whether the carrying value of goodwill may not be recoverable include, but are not limited to: significant changes in performance relative to expected operating results; significant changes in the use of the assets; significant negative industry or economic trends; and a significant decline in the Company's stock price and/or market capitalization for a sustained period of time. If our stock price were to trade below book value per share for an extended period of time and/or we continue to experience adverse effects of a continued downward trend in the overall economic environment, changes in the business itself, including changes in projected earnings and cash flows, we may have to recognize an impairment of all or some portion of our goodwill. An impairment loss is

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recognized to the extent that the carrying amount exceeds the asset's fair value. If the fair value is lower than the carrying value, a material impairment charge may be reported in our financial results. We exercise judgment in the assessment of the related useful lives of intangible assets, the fair values and the recoverability. In certain instances, the fair value is determined in part based on cash flow forecasts and discount rate estimates. We review our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, amortization expense is increased or decreased. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset group to estimated undiscounted future cash flows expected to be generated by the asset group. If such asset group is considered to be impaired, the impairment is to be recognized by the amount by which the carrying amount of the assets exceeds fair value. Assets to be disposed of are separately presented on the balance sheet and reported at the lower of their carrying amount or fair value less costs to sell, and are no longer depreciated. We cannot accurately predict the amount and timing of any impairment of goodwill or other intangible assets. Should the value of goodwill or other intangible assets become impaired, we would record the appropriate charge, which could have an adverse effect on our financial condition and results of operations.

We initiated our annual goodwill impairment analysis in the fourth quarter of 2012 and concluded that the fair value was below the carrying value for the Archeo reporting unit and recognized an impairment loss of \$16.7 million. The estimated fair value of the Archeo reporting unit was based on estimates of future operating results, discounted cash flows, and other market-based factors. The goodwill impairment recorded within the Archeo reporting unit resulted from the newly associated amounts of goodwill allocated upon the commencement of the reporting unit designation in the fourth quarter, and the operating results including lower projected revenue growth rates and profitability levels compared to historical results. The lower projected operating results reflect changes in assumptions related to organic revenue growth rates, market trends, business mix, cost structure, and other expectations about the anticipated short-term and long-term operating results of the Archeo reporting unit.

No impairment of our other intangible assets have been identified in 2010, 2011 or 2012. The current business environment is subject to evolving market conditions and requires significant management judgment to interpret the potential impact to our assumptions. To the extent that changes in the current business environment impact our ability to achieve levels of forecasted operating results and cash flows, or should other events occur indicating the remaining carrying value of our assets might be impaired, we would test our intangible assets for impairment and may recognize an additional impairment loss to the extent that the carrying amount exceeds such asset's fair value.

Any future additional impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

***Stock-Based Compensation***

FASB ASC 718 requires the measurement and recognition of compensation for all stock-based awards made to employees, non-employees and directors including stock options, restricted stock issuances, and restricted stock units based on estimated fair values. Under the fair value recognition provisions, we recognize stock-based compensation net of an estimated forfeiture rate, and therefore only recognize compensation cost for those shares expected to vest over the requisite service period.

We generally use the Black-Scholes option pricing model as our method of valuation for stock-based awards with time-based vesting. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors. For stock-based awards with time-based vesting, we are required to estimate the expected forfeiture rate and only recognize

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expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience of our stock-based awards that are granted, exercised and cancelled. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

During 2011 and 2012, we issued equity awards of stock options, restricted stock awards, and restricted stock units that have vesting based on a combination of certain service and market conditions. For equity awards with vesting based on a combination of certain service and market conditions, we factor an estimated probability of achieving certain service and market conditions and recognize compensation cost over the requisite service period of the award. We used a binomial lattice model to determine the fair value for each tranche and a Monte Carlo simulation to determine the derived service period for each tranche.

Although the fair value of stock-based awards is determined in accordance with FASB ASC 718, the assumptions used in calculating fair value of stock-based awards, the use of the Black-Scholes option pricing model, and the use of the binomial lattice model and a Monte Carlo simulation are highly subjective, and other reasonable assumptions could provide differing results. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. See Note 6 (b) *Stock Option Plan* in the consolidated financial statements for additional information.

***Allowance for Doubtful Accounts and Advertiser Credits***

Accounts receivable balances are presented net of allowance for doubtful accounts and advertiser credits. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our accounts receivable. We determine our allowance based on analysis of historical bad debts, advertiser concentrations, advertiser creditworthiness and current economic trends. We review the allowance for collectability on a quarterly basis. Account balances are written off against the allowance after all reasonable means of collection have been exhausted and the potential recovery is considered remote. If the financial condition of our advertisers were to deteriorate, resulting in an impairment of their ability to make payments, or if we underestimated the allowances required, additional allowances may be required which would result in increased general and administrative expenses in the period such determination was made.

We determine our allowance for advertiser credits and adjustments based upon our analysis of historical credits. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments and estimates.

***Provision for Income Taxes***

We utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax law is recognized in results of operations in the period that includes the enactment date.

Each reporting period we must assess the likelihood that our deferred tax assets will be recovered from existing deferred tax liabilities or future taxable income, and to the extent that realization is not more likely than not, a valuation allowance must be established. The establishment of a valuation allowance and increases to such an allowance may result in either increases to income tax expense or reduction of income tax benefit in the statement of operations. At the end of fourth quarter 2012, we recognized a partial valuation allowance of \$16.4 million on our federal deferred tax assets. In assessing whether it is more likely than not that our deferred tax assets will be realized, factors considered included: historical taxable income, historical trends related to

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advertiser usage rates, projected revenues and expenses, macroeconomic conditions, issues facing our industry, existing contracts, our ability to project future results and any appreciation of our other assets. During the fourth quarter of 2012, we incurred a \$16.7 million goodwill impairment loss within our Archeo operating segment due in part to lower projected revenue growth rates and profitability levels within Archeo compared to historical results.

The majority of the deferred tax assets have arisen due to deductions taken in the financial statements related to the impairment of goodwill and the amortization of intangible assets recorded in connection with various acquisitions that are tax-deductible over 15 year periods. Consequently, based on projections of future taxable income and tax planning strategies, we expect to be able to recover a portion of these assets. Although realization is not assured, we believe it is more likely than not, based on our operating performance, existing deferred tax liabilities, projections of future taxable income and tax planning strategies, that our net deferred tax assets, excluding certain state and foreign net operating loss carryforwards, will be realized. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if our projections of future taxable income are reduced or if we do not perform at the levels we are projecting. This could result in increases to the valuation allowance for deferred tax assets and a corresponding increase to income tax expense of up to the entire net amount of deferred tax assets.

As of December 31, 2012, we have net deferred tax assets of \$28.5 million, relating to the impairment of goodwill, amortization of intangibles assets, certain other temporary differences, acquired federal and state net operating loss carryforwards, and research and development credits. We have recorded a valuation allowance of \$16.4 million against our federal net deferred tax assets as of December 31, 2012 as we believe it is more likely than not that these benefits will not be realized. In addition, as of December 31, 2012, based upon both positive and negative evidence available, we have determined it is not more likely than not that certain deferred tax assets relating to net operating loss carryforwards in certain state, city and foreign jurisdictions will be realizable and accordingly, have recorded a 100% valuation allowance of \$5.2 million against these deferred tax assets. We do not have a history of taxable income in the relevant jurisdictions and the state and foreign net operating loss carryforwards will more likely than not expire unutilized. Should we determine in the future that we will be able to realize these deferred tax assets, or not be able to realize all or part of our remaining net deferred tax assets recorded as of December 31, 2012, an adjustment to the net deferred tax assets would impact net income or stockholders' equity in the period such determination was made.

As of December 31, 2011 and 2012, we had certain federal NOL carryforwards of \$1.7 million which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. We believe that such a change has occurred, and that approximately \$1.7 million of NOL carryforwards is limited such that substantially all of these federal NOL carryforwards will never be available. Accordingly, we have not recorded a deferred tax asset for these NOLs.

In connection with the Jingle acquisition in 2011, we acquired federal NOL carryforwards. Where there is a change in ownership within the meaning of Section 382 of the Internal Revenue Code, the acquired federal net operating loss carryforwards are subject to an annual limitation. The Company believes that such an ownership change had occurred at Jingle, and that the utilization of the carryforwards is limited such that the majority of the NOL carryforwards will never be utilized. Accordingly, we have not recorded those amounts we believe it will not be able to utilize and has not included those NOL carryforwards in its deferred tax assets. Our NOL carryforwards that may be utilized is approximately \$7.0 million. In 2011, the Company utilized approximately \$2.6 million.

From time to time, various state, federal, and other jurisdictional tax authorities undertake reviews of us and our filings. We believe any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

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FASB ASC 740 clarifies the accounting for uncertainty in income taxes recognized in the financial statements. This pronouncement prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in the our tax return. FASB ASC 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions.

### **Recent Accounting Pronouncements**

In July 2012, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2012-02, *Intangibles - Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment* (ASU 2012-02), to allow entities to use a qualitative approach to test indefinite-lived intangible assets for impairment. ASU 2012-02 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012 and early adoption is permitted. The Company is currently evaluating the impact of the adoption of ASU 2012-02 on the consolidated financial statements.

### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Our exposure to market risk is limited to interest income sensitivity, which is affected by changes in the general level of U.S. interest rates, particularly because the majority of our investments are in short-term, money market funds. We place our investments with high-quality financial institutions. During the years ended December 31, 2011 and 2012, the effects of changes in interest rates on the fair market value of our investments and our earnings were not material. Further, we believe that the impact on the fair market value of our investments and our earnings from a hypothetical 10% change in interest rates would not be significant. We do not have any material foreign currency or other derivative financial instruments.

Our existing credit facility bears interest at a rate which will be, at our option, either: (i) the applicable margin rate (depending on our leverage) plus the one-month LIBOR rate reset daily, or (ii) the applicable margin rate plus the 1, 2, 3, or 6-month LIBOR rate. This facility is exposed to market rate fluctuations and may impact the interest paid on any borrowings under the credit facility. Currently, we have no borrowings under this facility; however, an increase in interest rates would impact interest expense on future borrowings.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.  
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders

Marchex, Inc.:

We have audited the accompanying consolidated balance sheets of Marchex, Inc. and subsidiaries as of December 31, 2011 and 2012, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Marchex, Inc. and subsidiaries as of December 31, 2011 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 12, 2013 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington

March 12, 2013

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders

Marchex, Inc.:

We have audited Marchex, Inc.'s internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Marchex, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Marchex, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Marchex, Inc. and subsidiaries as of December 31, 2011 and 2012, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012, and our report dated March 12, 2013 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington

March 12, 2013

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Consolidated Balance Sheets****(in thousands, except per share amounts)**

|   | <b>As of December 31,</b> |                   |
|---|---------------------------|-------------------|
|   | <b>2011</b>               | <b>2012</b>       |
| <b>Assets</b>   |                           |                   |
| Current assets:   |                           |                   |
| Cash and cash equivalents   | \$ 37,443                 | \$ 15,930         |
| Accounts receivable, net  | 30,635                    | 25,988            |
| Prepaid expenses and other current assets   | 3,614                     | 2,667             |
| Refundable taxes  | 193                       | 264               |
| Deferred tax assets   | 2,753                     | 830               |
| <b>Total current assets</b>   | <b>74,638</b>             | <b>45,679</b>     |
| Property and equipment, net   | 6,187                     | 6,005             |
| Deferred tax assets   | 46,310                    | 27,677            |
| Intangible and other assets, net  | 2,191                     | 611               |
| Goodwill  | 82,644                    | 65,815            |
| Intangible assets from acquisitions, net  | 8,088                     | 3,360             |
| <b>Total assets</b>   | <b>\$ 220,058</b>         | <b>\$ 149,147</b> |
| <b>Liabilities and Stockholders Equity</b>  |                           |                   |
| Current liabilities:  |                           |                   |
| Accounts payable  | \$ 12,896                 | \$ 12,378         |
| Accrued expenses and other current liabilities  | 8,430                     | 9,609             |
| Deferred acquisition payments   | 35,214                    |                   |
| Deferred revenue  | 1,930                     | 2,009             |
| <b>Total current liabilities</b>  | <b>58,470</b>             | <b>23,996</b>     |
| Other non-current liabilities   | 2,580                     | 2,216             |
| <b>Total liabilities</b>  | <b>61,050</b>             | <b>26,212</b>     |
| Commitments and contingencies   |                           |                   |
| Stockholders equity:  |                           |                   |
| Common stock, \$.01 par value. Authorized 137,500 shares;   |                           |                   |
| Class A: 12,500 shares authorized; 9,894 and 9,632 shares issued and outstanding, respectively, at December 31, 2011; 9,832 and 9,570 shares issued and outstanding, respectively, at December 31, 2012   | 99                        | 98                |
| Class B: 125,000 shares authorized; 28,074 and 27,917 shares issued and outstanding, respectively, at December 31, 2011, including 3,995 of restricted stock at December 31, 2011; and 28,380 and 27,978 shares issued and outstanding, respectively, at December 31, 2012, including 2,433 restricted stock at December 31, 2012 | 281                       | 284               |
| Treasury stock: 157 and 402 shares of Class B stock at December 31, 2011 and 2012, respectively   | (1,067)                   | (13)              |
| Additional paid-in capital  | 297,465                   | 295,532           |
| Accumulated deficit   | (137,770)                 | (172,966)         |
| <b>Total stockholders equity</b>  | <b>159,008</b>            | <b>122,935</b>    |
| <b>Total liabilities and stockholders equity</b>  | <b>\$ 220,058</b>         | <b>\$ 149,147</b> |

See accompanying notes to consolidated financial statements.



**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Consolidated Statements of Operations****(in thousands, except per share amounts)**

|  | Years ended December 31, |            |             |
|--|--------------------------|------------|-------------|
|  | 2010                     | 2011       | 2012        |
| Revenue  | \$ 97,566                | \$ 146,726 | \$ 138,305  |
| Expenses:  |                          |            |             |
| Service costs <sup>(1)</sup>   | 57,557                   | 81,835     | 80,594      |
| Sales and marketing <sup>(1)</sup>   | 13,530                   | 15,434     | 13,671      |
| Product development <sup>(1)</sup>   | 16,804                   | 22,794     | 23,395      |
| General and administrative <sup>(1)</sup>  | 17,507                   | 22,709     | 22,911      |
| Amortization of intangible assets from acquisitions <sup>(2)</sup>                             | 2,729                    | 5,455      | 4,728       |
| Acquisition and separation related costs   |                          | 1,890      | 753         |
| Total operating expenses   | 108,127                  | 150,117    | 146,052     |
| Impairment of goodwill   |                          |            | (16,739)    |
| Gain on sales and disposals of intangible assets, net  | 6,772                    | 9,421      | 6,296       |
| Income (loss) from operations  | (3,789)                  | 6,030      | (18,190)    |
| Other income (expense):  |                          |            |             |
| Interest income  | 76                       | 141        | 14          |
| Interest and line of credit expense  | (107)                    | (604)      | (438)       |
| Other  | 160                      | 5          | (25)        |
| Total other income (expense)   | 129                      | (458)      | (449)       |
| Income (loss) before provision for income taxes  | (3,660)                  | 5,572      | (18,639)    |
| Income tax expense (benefit)   | (617)                    | 2,613      | 16,557      |
| Net income (loss)  | (3,043)                  | 2,959      | (35,196)    |
| Dividends paid to participating securities   | (199)                    | (259)      | (657)       |
| Net income (loss) applicable to common stockholders  | \$ (3,242)               | \$ 2,700   | \$ (35,853) |
| Basic and diluted net income (loss) per share applicable to common stockholders                |                          |            |             |
| Class A  | \$ (0.10)                | \$ 0.08    | \$ (1.06)   |
| Class B  | \$ (0.10)                | \$ 0.08    | \$ (1.05)   |
| Dividends paid per share   | \$ 0.08                  | \$ 0.08    | \$ 0.25     |
| Shares used to calculate basic net income (loss) per share applicable to common stockholders   |                          |            |             |
| Class A  | 10,661                   | 9,928      | 9,574       |
| Class B  | 21,993                   | 23,358     | 24,412      |
| Shares used to calculate diluted net income (loss) per share applicable to common stockholders |                          |            |             |
| Class A  | 10,661                   | 9,928      | 9,574       |
| Class B  | 32,654                   | 35,318     | 33,986      |

<sup>(1)</sup> Excludes amortization of intangible assets from acquisitions.<sup>(2)</sup> Components of amortization of intangible assets from acquisitions:

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|                            |          |          |          |
|----------------------------|----------|----------|----------|
| Service costs              | \$ 2,729 | \$ 4,515 | \$ 3,484 |
| Sales and marketing        |          | 897      | 1,228    |
| General and administrative |          | 43       | 16       |
| Total                      | \$ 2,729 | \$ 5,455 | \$ 4,728 |

See accompanying notes to consolidated financial statements.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders' Equity**

(in thousands)

|  | Class A<br>common stock |        | Class B<br>common stock |        | Treasury stock |            | Additional<br>paid-in<br>capital | Accumulated<br>deficit | Total<br>stockholders<br>equity |
|--|-------------------------|--------|-------------------------|--------|----------------|------------|----------------------------------|------------------------|---------------------------------|
|  | Shares                  | Amount | Shares                  | Amount | Shares         | Amount     |                                  |                        |                                 |
| Balances at December 31, 2009  | 10,869                  | \$ 111 | 25,194                  | \$ 252 | (695)          | \$ (3,205) | \$ 281,953                       | \$ (137,686)           | \$ 141,425                      |
| Issuance of common stock upon exercise of stock options                            |                         |        | 82                      | 1      |                |            | 371                              |                        | 372                             |
| Income tax shortfall of option exercises and restricted stock vesting, net         |                         |        |                         |        |                |            | (537)                            |                        | (537)                           |
| Issuance of common stock under employee stock purchase plan                        |                         |        | 3                       |        |                |            | 17                               |                        | 17                              |
| Issuance of restricted stock to employees  |                         |        | 1,358                   | 14     |                |            |                                  |                        | 14                              |
| Repurchase of Class B common stock   |                         |        |                         |        | (1,234)        | (6,534)    |                                  |                        | (6,534)                         |
| Conversion of Class A common stock to Class B common stock                         | (631)                   | (6)    | 631                     | 6      |                |            |                                  |                        |                                 |
| Repurchase of unvested restricted stock  |                         |        |                         |        | (82)           | (1)        |                                  |                        | (1)                             |
| Stock compensation from options and restricted stock, net of estimated forfeitures |                         |        |                         |        |                |            | 10,795                           |                        | 10,795                          |
| Retirement of treasury stock   |                         |        | (1,788)                 | (18)   | 1,788          | 8,380      | (8,362)                          |                        |                                 |
| Net loss   |                         |        |                         |        |                |            |                                  | (3,043)                | (3,043)                         |
| Common stock cash dividends  |                         |        |                         |        |                |            | (2,816)                          |                        | (2,816)                         |
| Balances at December 31, 2010  | 10,238                  | \$ 105 | 25,480                  | \$ 255 | (223)          | \$ (1,360) | \$ 281,421                       | \$ (140,729)           | \$ 139,692                      |
| Issuance of common stock upon exercise of stock options                            |                         |        | 411                     | 4      |                |            | 1,753                            |                        | 1,757                           |
| Income tax shortfall of option exercises and restricted stock vesting, net         |                         |        |                         |        |                |            | 913                              |                        | 913                             |
| Issuance of common stock under employee stock purchase plan                        |                         |        | 4                       |        |                |            | 26                               |                        | 26                              |
| Issuance of common stock in connection with acquisition                            |                         |        | 1,019                   | 10     |                |            | 7,593                            |                        | 7,603                           |
| Issuance of restricted stock to employees  |                         |        | 1,103                   | 11     |                |            |                                  |                        | 11                              |
| Issuance of restricted stock to employees as part of acquisitions                  |                         |        | 462                     | 5      |                |            |                                  |                        | 5                               |
| Repurchase of Class B common stock   |                         |        |                         |        | (883)          | (6,159)    |                                  |                        | (6,159)                         |
| Conversion of Class A common stock to Class B common stock                         | (606)                   | (6)    | 606                     | 6      |                |            |                                  |                        |                                 |
| Repurchase of unvested restricted stock  |                         |        |                         |        | (62)           | (1)        |                                  |                        | (1)                             |
| Stock compensation from options and restricted stock, net of estimated forfeitures |                         |        |                         |        |                |            | 15,140                           |                        | 15,140                          |
| Retirement of treasury stock   |                         |        | (1,011)                 | (10)   | 1,011          | 6,453      | (6,443)                          |                        |                                 |
| Net income   |                         |        |                         |        |                |            |                                  | 2,959                  | 2,959                           |
| Common stock cash dividends  |                         |        |                         |        |                |            | (2,938)                          |                        | (2,938)                         |
| Balances at December 31, 2011  | 9,632                   | \$ 99  | 28,074                  | \$ 281 | (157)          | \$ (1,067) | \$ 297,465                       | \$ (137,770)           | \$ 159,008                      |
| Issuance of common stock upon exercise of stock options                            |                         |        | 6                       |        |                |            | 27                               |                        | 27                              |
| Income tax shortfall of option exercises and restricted stock vesting, net         |                         |        |                         |        |                |            | (4,006)                          |                        | (4,006)                         |
| Issuance of common stock under employee stock purchase plan                        |                         |        | 10                      |        |                |            | 36                               |                        | 36                              |

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|  |         |       |        |         |         |         |            |              |    |          |
|--|---------|-------|--------|---------|---------|---------|------------|--------------|----|----------|
| Issuance of restricted stock to employees  | 1,484   | 15    |        |         |         |         |            |              |    | 15       |
| Tax withholding related to restricted stock awards                                 | (7)     |       | (384)  | (4)     | (1,607) |         |            |              |    | (1,611)  |
| Repurchase of Class B common stock   |         |       | (387)  | (1,651) |         |         |            |              |    | (1,651)  |
| Conversion of Class A common stock to Class B common stock                         | (62)    | (1)   | 62     | 1       |         |         |            |              |    |          |
| Repurchase of unvested restricted stock  |         |       |        |         | (723)   | (7)     |            |              |    | (7)      |
| Stock compensation from options and restricted stock, net of estimated forfeitures |         |       |        |         |         |         | 15,696     |              |    | 15,696   |
| Retirement of treasury stock   | (1,249) | (13)  | 1,249  | 2,716   | (2,703) |         |            |              |    |          |
| Net loss   |         |       |        |         |         |         |            | (35,196)     |    | (35,196) |
| Common stock cash dividends  |         |       |        |         |         |         |            | (9,376)      |    | (9,376)  |
| Balances at December 31, 2012  | 9,570   | \$ 98 | 28,380 | \$ 284  | (402)   | \$ (13) | \$ 295,532 | \$ (172,966) | \$ | 122,935  |

See accompanying notes to consolidated financial statements.



**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

(in thousands)

|  | Years ended December 31, |          |             |
|--|--------------------------|----------|-------------|
|  | 2010                     | 2011     | 2012        |
| Cash flows from operating activities:  |                          |          |             |
| Net income (loss)  | \$ (3,043)               | \$ 2,959 | \$ (35,196) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities:                           |                          |          |             |
| Amortization and depreciation  | 7,694                    | 9,473    | 8,457       |
| Accretion of interest expense  |                          | 519      | 362         |
| Acquisition related costs  |                          | 372      | (132)       |
| Leasehold improvement incentive  | 779                      | 204      |             |
| Impairment of goodwill   |                          |          | 16,739      |
| Gain on sales of fixed assets, net   | (2)                      | (4)      |             |
| Gain on sales and disposals of intangible assets, net  | (6,772)                  | (9,421)  | (6,296)     |
| Allowance for doubtful accounts and advertiser credits   | 1,348                    | 1,203    | 1,780       |
| Stock-based compensation   | 10,832                   | 15,143   | 15,696      |
| Deferred income taxes  | 2,004                    | 1,895    | 16,586      |
| Excess tax benefit related to stock-based compensation   | (36)                     | (1,032)  | (308)       |
| Change in certain assets and liabilities, net of acquisition:  |                          |          |             |
| Accounts receivable, net   | (6,778)                  | (6,965)  | 2,948       |
| Refundable taxes, net  | 1,631                    | 4,006    | (100)       |
| Prepaid expenses and other current assets  | (988)                    | (1,618)  | 1,884       |
| Accounts payable   | 2,486                    | (1,542)  | (550)       |
| Accrued expenses and other current liabilities   | (320)                    | 1,195    | (1,704)     |
| Deferred revenue   | (307)                    | 210      | 79          |
| Other non-current liabilities  | 860                      | 185      | (344)       |
| Net cash provided by operating activities  | 9,388                    | 16,782   | 19,901      |
| Cash flows from investing activities:  |                          |          |             |
| Purchases of property and equipment  | (3,441)                  | (3,971)  | (2,879)     |
| Cash paid for acquisitions, net of cash acquired   |                          | (15,801) |             |
| Proceeds from sales of property and equipment  | 1                        | 9        |             |
| Proceeds from sales of intangible assets   | 6,779                    | 9,474    | 6,319       |
| Purchases of intangibles and changes in other non-current assets   | (116)                    | (103)    | (120)       |
| Net cash provided by (used in) investing activities  | 3,223                    | (10,392) | 3,320       |
| Cash flows from financing activities:  |                          |          |             |
| Capital lease obligation principal payments  | (6)                      |          |             |
| Excess tax benefit related to stock options  | 36                       | 1,032    | 308         |
| Tax withholding related to restricted stock awards   |                          |          | (226)       |
| Repurchase of Class B common stock for treasury stock  | (6,534)                  | (6,159)  | (1,651)     |
| Common stock dividends payments  | (2,816)                  | (2,938)  | (9,376)     |
| Proceeds from exercises of stock options   | 372                      | 1,754    | 27          |
| Proceeds from issuance of restricted stock to employees, net of repurchases of forfeited unvested restricted stock | 10                       | 10       | 8           |
| Deferred acquisition payments  |                          |          | (33,860)    |
| Proceeds from employee stock purchase plan   | 17                       | 26       | 36          |
| Net cash used in financing activities  | (8,921)                  | (6,275)  | (44,734)    |

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|  |   |           |           |
|--|---|-----------|-----------|
| Net increase (decrease) in cash and cash equivalents   | 3,690   | 115       | (21,513)  |
| Cash and cash equivalents at beginning of period   | 33,638  | 37,328    | 37,443    |
| Cash and cash equivalents at end of period   | \$ 37,328   | \$ 37,443 | \$ 15,930 |
| Supplemental disclosure of cash flow information:  |   |           |           |
| Cash received during the period for income taxes, net of payments                                  | (4,336)   | (2,994)   | 117       |
| Cash paid during the period for interest accretion on deferred payment                             |   |           | 881       |
| Cash paid (received) during the period for interest, net   | 77  | (63)      | (62)      |
| Supplemental disclosure of non-cash investing and financing activities:                            |   |           |           |
| Fair value of Class B common stock issued in connection with acquisition                           |   | 7,603     |           |
| Deferred payments related to acquisition   |   | 34,695    | 835       |
| Property and equipment acquired in accounts payable and accrued expenses                           | 54  | 121       | 239       |
| Tax withholding related to restricted stock awards in accrued expenses                             |   |           | 1,384     |
| Leasehold improvement incentive recorded in other current assets and other non-current liabilities | 211   |           |           |
|  | See accompanying notes to consolidated financial statements |           |           |

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**MARCHEX, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(1) Description of Business and Summary of Significant Accounting Policies and Practices**

***(a) Description of Business and Basis of Presentation***

Marchex, Inc. (the Company) was incorporated in the state of Delaware on January 17, 2003. The Company is a mobile performance advertising company that delivers consumer calls to businesses and analyzes those calls. The Company also provides performance-based online advertising that connects advertisers with consumers across its proprietary network of owned web sites as well as third party web sites.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Acquisitions are included in the Company's consolidated financial statements as of and from the date of acquisition. The Company's purchase accounting resulted in all assets and liabilities of acquired businesses being recorded at their estimated fair values on the acquisition dates. All inter-company transactions and balances have been eliminated in consolidation. Certain reclassifications have been made to the consolidated financial statements in the prior periods to conform to the current period presentation.

*Acquisition*

On April 7, 2011, the Company acquired 100% of the stock of Jingle Networks, Inc. (Jingle), a provider of mobile voice search performance advertising and technology solutions in North America. See Note 9 for further discussion.

*Proposed Separation*

On November 1, 2012, the Company announced that its board of directors has authorized the Company to pursue the separation of its business into two distinct publicly traded entities. The separation is expected to be a tax-free pro rata distribution in which the Company's existing shareholders would hold interests in: (1) Marchex, a mobile advertising company focused on calls, and (2) Archeo, Inc. (Archeo), a domain and advertising marketplace. Completion of the proposed separation is subject to certain conditions, including final approval by the Company's board of directors, receipt of regulatory approvals, favorable tax rulings and/or opinions regarding the tax-free nature of the transaction to the Company and to its shareholders, further due diligence as appropriate, and the filing and effectiveness of appropriate filings with the Securities and Exchange Commission.

***(b) Cash and Cash Equivalents***

The Company considers all highly liquid investments with an original maturity of three months or less at the date of purchase to be cash equivalents. Cash equivalents consist primarily of money market funds.

***(c) Fair Value of Financial Instruments***

The Company had the following financial instruments as of December 31, 2011 and 2012: cash and cash equivalents, accounts receivable, refundable taxes, accounts payable and accrued liabilities. The carrying value of cash and cash equivalents, accounts receivable, refundable taxes, accounts payable and accrued liabilities approximates their fair value based on the liquidity of these financial instruments or based on their short-term nature.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****(d) Accounts Receivable**

Accounts receivable are recorded at the invoiced amount and do not bear interest. Accounts receivable balances are presented net of allowance for doubtful accounts and allowance for advertiser credits.

*Allowance for Doubtful Accounts*

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in existing accounts receivable. The Company determines the allowance based on analysis of historical bad debts, advertiser concentrations, advertiser credit-worthiness and current economic trends. Past due balances over 90 days and specific other balances are reviewed individually for collectibility. The Company reviews the allowance for collectibility quarterly. Account balances are written off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

The allowance for doubtful account activity for the periods indicated is as follows (in thousands):

|                   | Balance at<br>beginning<br>of period | Charged to<br>costs and<br>expenses | Write-offs,<br>net of<br>recoveries | Balance at<br>end of<br>period |
|-------------------|--------------------------------------|-------------------------------------|-------------------------------------|--------------------------------|
| December 31, 2010 | \$ 467                               | \$ 343                              | \$ 353                              | \$ 457                         |
| December 31, 2011 | 457                                  | 453                                 | 117                                 | 793                            |
| December 31, 2012 | 793                                  | 594                                 | 810                                 | 577                            |

*Allowance for Advertiser Credits*

The allowance for advertiser credits is the Company's best estimate of the amount of expected future reductions in advertisers' payment obligations related to delivered services. The Company determines the allowance for advertiser credits and adjustments based on analysis of historical credits.

The allowance for advertiser credits activity for the periods indicated is as follows (in thousands):

|                   | Balance at<br>beginning<br>of period | Additions charged<br>against revenue | Credits<br>processed | Balance at<br>end of<br>period |
|-------------------|--------------------------------------|--------------------------------------|----------------------|--------------------------------|
| December 31, 2010 | \$ 464                               | \$ 1,005                             | \$ 830               | \$ 639                         |
| December 31, 2011 | 639                                  | 690                                  | 856                  | 473                            |
| December 31, 2012 | 473                                  | 1,186                                | 1,074                | 585                            |

**(e) Property and Equipment**

Property and equipment are stated at cost. Depreciation on computers and other related equipment, purchased and internally developed software, and furniture and fixtures is calculated on the straight-line method over the estimated useful lives of the assets, generally averaging three years. Leasehold improvements are amortized straight-line over the shorter of the lease term or estimated useful lives of the assets ranging from three to eight years.

**(f) Goodwill**

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Goodwill represents the excess of the purchase price over the fair value of identifiable assets acquired and liabilities assumed in business combinations accounted for under the purchase method.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The Company applies the provisions of FASB ASC 350 *Goodwill and Intangible Assets*. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of FASB ASC 350. FASB ASC 350 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with FASB ASC 360.

**(g) Impairment or Disposal of Long-Lived Assets**

The Company reviews its long-lived assets for impairment in accordance with FASB ASC 360 whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds fair value. Assets to be disposed of would be separately presented on the balance sheet and reported at the lower of their carrying amount or fair value less costs to sell, and no longer depreciated.

**(h) Revenue Recognition**

The following table presents our revenues, by revenue source, for the periods presented (in thousands):

|                                      | Years ended December 31, |                   |                   |
|--------------------------------------|--------------------------|-------------------|-------------------|
|                                      | 2010                     | 2011              | 2012              |
| Partner and Other Revenue Sources    | \$ 71,537                | \$ 126,210        | \$ 127,415        |
| Proprietary Web site Traffic Sources | 26,029                   | 20,516            | 10,890            |
| <b>Total Revenue</b>                 | <b>\$ 97,566</b>         | <b>\$ 146,726</b> | <b>\$ 138,305</b> |

The Company's partner network revenues are primarily generated using third party distribution networks to deliver advertisers' listings. The distribution network includes mobile and online search engines and applications, directories, destination sites, shopping engines, third party Internet domains or web sites, other targeted Web-based content, mobile carriers and other offline sources. The Company generates revenue upon delivery of qualified and reported phone calls or click-throughs to our advertisers or to advertising services providers' listings. The Company pays a revenue share to the distribution partners to access their mobile, online, offline and other user traffic. Other revenues include the Company's call provisioning and call tracking services, presence management services, and campaign management services.

The Company's proprietary web site traffic revenues are generated from the Company's portfolio of owned web sites which are monetized with pay-for-call or pay-per-click listings that are relevant to the web sites, as well as other forms of advertising, including banner advertising and sponsorships. When an online user navigates to one of the Company's owned and operated web sites and calls or clicks on a particular listing or completes the specified action, the Company receives a fee.

The Company's primary sources of revenue are the performance-based advertising services, which include digital call advertising, pay-per-click services, and cost-per-action services. These primary sources amounted to greater than 79% of revenue for the years ended December 31, 2010, 2011 and 2012. The secondary sources of revenue are the Local Leads platform which enables partner resellers to sell call advertising and/or search marketing products and campaign management services. These secondary sources amounted to less than 21% of revenue for the years ended December 31, 2010, 2011 and 2012. The Company has no barter transactions.

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**MARCHEX, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

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

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

In providing call advertising services and pay-per-click advertising, the Company generates revenue upon delivery of qualified and reported phone calls or click-throughs to advertisers or advertising service providers' listings. These advertisers and advertising service providers pay the Company a designated transaction fee for each phone call or click-through, which occurs when an online user makes a phone call or clicks on any of their advertisement listings after it has been placed by the Company or by the Company's distribution partners. Each phone call or click-through on an advertisement listing represents a completed transaction. The advertisement listings are displayed within the Company's distribution network, which includes mobile and online search engines and applications, directories, destination sites, shopping engines, third party Internet domains or web sites, the Company's portfolio of owned web sites and other targeted Web-based content and offline sources. The Company also generates revenue from cost-per-action services, which occurs when the online user is redirected from one of the Company's web sites or a third party web site in our distribution network to an advertiser web site and completes the specified action.

The Company generates revenue from reseller partners and publishers utilizing the Company's Local Leads platform to sell call advertising and/or search marketing products. The Company is paid account fees and also agency fees for the Company's products in the form of a percentage of the cost of every call or click delivered to advertisers. The reseller partners or publishers engage the advertisers and are the primary obligor, and the Company, in certain instances, is only financially liable to the publishers in the Company's capacity as a collection agency for the amount collected from the advertisers. The Company recognizes revenue for these fees under the net revenue recognition method. In limited arrangements resellers pay the Company a fee for fulfilling an advertiser's campaign in its distribution network and the Company acts as the primary obligor. The Company recognizes revenue for these fees under the gross revenue recognition method.

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

Advertisers pay the Company additional fees for services such as campaign management. Advertisers generally pay the Company on a click-through basis, although in certain cases the Company receives a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select advertisers. Banner advertising revenue may be based on a fixed fee per click and is generated and recognized on click-through activity. In other cases, banner payment terms are volume-based with revenue generated and recognized when impressions are delivered.

The Company enters into agreements with various distribution partners to provide distribution for pay-for-call and pay-per-click advertisement listings which contain call tracking numbers and/or URL strings of our

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**MARCHEX, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

advertisers. The Company generally pays distribution partners based on a percentage of revenue or a fixed amount per phone call or click-through on these listings. The Company acts as the primary obligor with the advertiser for revenue call or click-through transactions and is responsible for the fulfillment of services.

In accordance with FASB ASC 605, the revenue derived from advertisers is reported gross based upon the amounts received from the advertiser. The Company also recognizes revenue for certain agency contracts with advertisers under the net revenue recognition method. Under these specific agreements, the Company purchases listings on behalf of advertisers from mobile sources, search engines and applications, directories, other Web-based content providers and offline sources. The Company is paid account fees and also agency fees based on the total amount of the purchase made on behalf of these advertisers. Under these agreements, the advertisers are primarily responsible for choosing the publisher and determining pricing, and the Company, in certain instances, is only financially liable to the publisher for the amount collected from our advertisers. This creates a sequential liability for media purchases made on behalf of advertisers. In certain instances, the web publishers engage the advertisers directly and the Company is paid an agency fee based on the total amount of the purchase made by the advertiser. In limited arrangements resellers pay us a fee for fulfilling an advertiser's campaign in our distribution network and we act as the primary obligor. We recognize revenue for these fees under the gross revenue recognition method.

The Company applies FASB ASC 605 to account for revenue arrangements with multiple deliverables. FASB ASC 605 addresses certain aspects of accounting by a vendor for arrangements under which the vendor will perform multiple revenue-generating activities. When an arrangement involves multiple elements, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when the revenue recognition criteria, as described above, for each element are met. Fair value for each element is established based on the sales price charged when the same element is sold separately.

***(j) Service Costs***

The largest component of the Company's service costs consist of user acquisition costs that relate primarily to payments made to distribution partners for access to their mobile, online, and offline user traffic. The Company enters into agreements of varying durations with distribution partners that integrate the Company's services into their web sites and indexes. The primary payment structure of the distribution partner agreements is a variable payment based on a specified percentage of revenue. These variable payments are often subject to minimum payment amounts per phone call or click-through. Other payment structures that to a lesser degree exist include: 1) fixed payments, based on a guaranteed minimum amount of usage delivered, 2) variable payments based on a specified metric, such as number of paid click-throughs, and 3) a combination arrangement with both fixed and variable amounts that may be paid in advance.

The Company expenses user acquisition costs based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments with minimum guaranteed amounts of usage are expensed as the greater of the pro-rata amount over the term of arrangement or the actual usage delivered to date based on the contractual revenue share. Agreements with variable payments based on a percentage of revenue, number of paid phone calls or click-throughs or other metrics are expensed as incurred based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Service costs also include network operations and customer service costs that consist primarily of costs associated with providing performance-based advertising and search marketing services, maintaining the Company's web sites, credit card processing fees, network costs and fees paid to outside service providers that provide the Company's paid listings and customer services. Customer service and other costs associated with



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**MARCHEX, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

serving the Company's search results and maintaining the Company's web sites include depreciation of web sites, network equipment and internally developed software, colocation charges of the Company's network web site equipment, bandwidth, software license fees, salaries of related personnel, stock-based compensation and amortization of intangible assets. Other service costs include license fees, the amortization of the purchase cost of domain names, the costs incurred for the renewal of the domain name registration and telecommunication costs, including the use of telephone numbers for providing call-based advertising services.

***(k) Advertising Expenses***

Advertising costs are expensed as incurred and include Internet-based advertising, sponsorships, and trade shows. Such costs are included in sales and marketing. The amounts for online and related outside marketing activities were approximately \$3.8 million, \$3.3 million and \$1.9 million for the years ended December 31, 2010, 2011 and 2012, respectively.

***(l) Other Intangible Assets and Product Development***

The Company capitalizes costs incurred to acquire domain names or URLs, which include the initial registration fees, and amortizes the costs over the expected useful life of the domain names on a straight-line basis. The expected useful lives range from 12 to 84 months. In order to maintain the rights to each domain name acquired, the Company pays periodic registration fees, which generally cover a minimum period of 12 months. The Company records registration renewal fees of domain name intangible assets as a prepaid expense and recognizes the cost over the renewal period. Product development costs consist primarily of expenses incurred by the Company in the research and development, creation, and enhancement of the Company's Internet sites and services. Research and development costs are expensed as incurred and include compensation and related expenses, costs of computer hardware and software, and costs incurred in developing features and functionality of the services. For the periods presented, substantially all of the product development expenses are research and development.

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with FASB ASC 350. FASB ASC 350 requires that cost incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

***(m) Income Taxes***

The Company utilizes the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax laws or rates is recognized in results of operations in the period that includes the enactment date. A valuation allowance is recorded for deferred tax assets when it is more likely than not that such deferred tax assets will not be realized.

***(n) Stock-Based Compensation***

The Company measures stock-based compensation cost at the grant date based on the fair value of the award and recognize it as expense, net of estimated forfeitures, over the vesting or service period, as applicable, of the stock award using the straight-line method.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****(o) Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The Company has used estimates related to several financial statement amounts, including revenues, allowance for doubtful accounts, allowance for advertiser credits, useful lives for property and equipment, intangible assets, the fair-value of the Company's common stock and stock option awards, the impairment of goodwill and intangible assets and a valuation allowance for deferred tax assets. Actual results could differ from those estimates.

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

**(p) Concentrations**

The Company maintains substantially all of its cash and cash equivalents with one financial institution and are all considered at Level 1 fair value with observable inputs that reflect quoted prices for identical assets or liabilities in active markets.

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

There were no distribution partners representing more than 10% of consolidated revenue for the years ended December 31, 2010, 2011 and 2012.

The advertisers representing more than 10% of consolidated revenue are as follows (in percentages):

|              | Years ended December 31, |      |      |
|--------------|--------------------------|------|------|
|              | 2010                     | 2011 | 2012 |
| Advertiser A | 23%                      | 31%  | 27%  |

Advertiser A is also a distribution partner.

The outstanding receivable balance for each advertiser representing more than 10% of consolidated accounts receivable is as follows (in percentages):

|              | At December 31, |      |
|--------------|-----------------|------|
|              | 2011            | 2012 |
| Advertiser A | 37%             | 36%  |
| Advertiser B | *               | 11%  |

\* Less than 10% of accounts receivable.



**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)*****(q) Net Income (Loss) Per Share***

The Company computes net income (loss) per share of Class A and Class B common stock using the two class method. Under the provisions of the two class method, basic net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the year. Diluted net income (loss) per share is computed by dividing net income (loss) applicable to common stockholder by the weighted average number of common and dilutive common equivalent shares outstanding during the period. The computation of the diluted net income (loss) per share of Class B common stock assumes the conversion of Class A common stock to Class B common stock, while the diluted net income (loss) per share of Class A common stock does not assume the conversion of those shares.

In accordance with the two class method, the undistributed earnings (losses) for each year are allocated based on the contractual participation rights of the Class A and Class B common shares and the restricted shares as if the earnings for the year had been distributed. Considering the terms of the Company's charter which provides that, if and when dividends are declared on our common stock in accordance with Delaware General Corporation Law, equivalent dividends shall be paid with respect to the shares of Class A common stock and Class B common stock and that both classes of common stock have identical dividend rights and would share equally in the Company's net assets in the event of liquidation, the Company has allocated undistributed earnings (losses) on a proportionate basis. Additionally, the Company has paid dividends equally to both classes of common stock and the unvested restricted shares since it initiated a quarterly cash dividend in November 2006.

Instruments granted in unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are participating securities prior to vesting. As such, the Company's restricted stock awards are considered participating securities for purposes of calculating earnings per share. Under the two class method, dividends paid on unvested restricted stock are allocated to these participating securities and therefore impacts the calculation of amounts allocated to common stock.

The following table calculates net income (loss) to net income (loss) applicable to common stockholders used to compute basic net income (loss) per share for the periods ended (in thousands, except per share amounts):

|   | Twelve months ended December 31, |            |         |          |             |             |
|---|----------------------------------|------------|---------|----------|-------------|-------------|
|   | 2010                             |            | 2011    |          | 2012        |             |
|   | Class A                          | Class B    | Class A | Class B  | Class A     | Class B     |
| <b>Numerator:</b>   |                                  |            |         |          |             |             |
| Net income (loss)   | \$ (1,058)                       | \$ (1,985) | \$ 799  | \$ 2,160 | \$ (10,164) | \$ (25,032) |
| Dividends paid to participating securities  |                                  | (199)      |         | (259)    |             | (657)       |
| Net income (loss) applicable to common stockholders   | \$ (1,058)                       | \$ (2,184) | \$ 799  | \$ 1,901 | \$ (10,164) | \$ (25,689) |
| <b>Denominator:</b>   |                                  |            |         |          |             |             |
| Weighted average number of shares outstanding used to calculate basic net income (loss) per share | 10,661                           | 21,993     | 9,928   | 23,358   | 9,574       | 24,412      |
| Basic net income (loss) per share applicable to common stockholders                               | \$ (0.10)                        | \$ (0.10)  | \$ 0.08 | \$ 0.08  | \$ (1.06)   | \$ (1.05)   |

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The following table calculates net income (loss) to diluted net income (loss) applicable to common stockholders used to compute diluted net income (loss) per share for the periods ended (in thousands, except per share amounts):

|   | Twelve months ended December 31, |                   |                |                 |                    |                    |
|---|----------------------------------|-------------------|----------------|-----------------|--------------------|--------------------|
|   | 2010                             |                   | 2011           |                 | 2012               |                    |
|   | Class A                          | Class B           | Class A        | Class B         | Class A            | Class B            |
| <b>Numerator:</b>   |                                  |                   |                |                 |                    |                    |
| Net income (loss)   | \$ (1,058)                       | \$ (1,985)        | \$ 799         | \$ 2,160        | \$ (10,164)        | \$ (25,032)        |
| Dividends paid to participating securities  |                                  | (199)             |                | (259)           |                    | (657)              |
| Reallocation of net income (loss) for Class A shares as a result of conversion of Class A to Class B shares |                                  | (1,058)           |                | 799             |                    | (10,164)           |
| <b>Net income (loss) applicable to common stockholders</b>  | <b>\$ (1,058)</b>                | <b>\$ (3,242)</b> | <b>\$ 799</b>  | <b>\$ 2,700</b> | <b>\$ (10,164)</b> | <b>\$ (35,853)</b> |
| <b>Denominator:</b>   |                                  |                   |                |                 |                    |                    |
| Weighted average number of shares outstanding used to calculate basic net income (loss) per share           | 10,661                           | 21,993            | 9,928          | 23,358          | 9,574              | 24,412             |
| Weighted average stock options and common shares subject to repurchase or cancellation                      |                                  |                   |                | 2,032           |                    |                    |
| Conversion of Class A to Class B common shares outstanding  |                                  | 10,661            |                | 9,928           |                    | 9,574              |
| <b>Weighted average number of shares outstanding used to calculate diluted net income (loss) per share</b>  | <b>10,661</b>                    | <b>32,654</b>     | <b>9,928</b>   | <b>35,318</b>   | <b>9,574</b>       | <b>33,986</b>      |
| <b>Diluted net income (loss) per share applicable to common stockholders</b>                                | <b>\$ (0.10)</b>                 | <b>\$ (0.10)</b>  | <b>\$ 0.08</b> | <b>\$ 0.08</b>  | <b>\$ (1.06)</b>   | <b>\$ (1.05)</b>   |

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

For the years ended December 31, 2010, 2011 and 2012, outstanding options to acquire 6,411, 4,792, and 7,029 shares, respectively, of Class B common stock.

For the years ended December 31, 2010, 2011, and 2012, 3,214, 134 and 2,433 shares, respectively, of unvested Class B restricted common shares issued to employees and in connection with acquisitions. These shares were for future services that vest over periods ranging from two to six years.

For the year ended December 31, 2011 and 2012, 153 and 131 restricted stock units with vesting based on meeting certain service and market conditions, respectively.

For the year ended December 31, 2011, 5,987 shares of Class B common stock that may be issued in lieu of cash for the deferred payments related to the acquisition of Jingle using the if converted method. See Note 9 for further discussion.

**(r) Guarantees**

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FASB ASC 460 provides accounting guidance surrounding liability recognition and disclosure requirements related to guarantees. In the ordinary course of business, the Company is not subject to potential obligations under guarantees that fall within the scope of FASB ASC 460 except for standard indemnification provisions that are contained within many of the Company's advertiser and distribution partner agreements, and give rise only to the disclosure requirements prescribed by FASB ASC 460.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

In certain agreements, the Company has agreed to indemnification provisions of varying scope and terms with advertisers, vendors and other parties with respect to certain matters, including, but not limited to, losses arising out of the Company's breach of agreements or representations and warranties made by the Company, services to be provided by the Company and intellectual property infringement claims made by third parties. As a result of these provisions, the Company may from time to time provide certain levels of financial support to contract parties to seek to minimize the impact of any associated litigation in which they may be involved. To date, there have been no known events or circumstances that have resulted in any material costs related to these indemnification provisions and no liabilities therefore have been recorded in the accompanying consolidated financial statements. However, the maximum potential amount of the future payments we could be required to make under these indemnification provisions could be material.

**(s) Deferred Acquisition Payment**

The Company's deferred acquisition payments represent consideration payable related to a business combination, which may be paid in either cash or shares of the Company's Series B common stock at the Company's discretion. Any deferred acquisition payments settled in common stock will be increased by 5%. The deferred acquisition payments were originally recognized at fair value at the date of the business combination and are recorded as liabilities on the balance sheet. Interest expense on the principal amounts due is accreted each period using the effective interest rate method. Both deferred acquisition payments were paid in cash in April 2012 and October 2012.

**(t) Recently Issued Accounting Standards**

In July 2012, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2012-02, *Intangibles - Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment* (ASU 2012-02), to allow entities to use a qualitative approach to test indefinite-lived intangible assets for impairment. ASU 2012-02 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012 and early adoption is permitted. The Company is currently evaluating the impact of the adoption of ASU 2012-02 on the consolidated financial statements.

**(2) Property and Equipment**

Property and equipment consisted of the following (in thousands):

|   | <b>Years ended December 31,</b> |                            |
|---|---------------------------------|----------------------------|
|   | <b>2011 <sup>(1)</sup></b>      | <b>2012 <sup>(1)</sup></b> |
| Computer and other related equipment            | \$ 13,671                       | \$ 15,842                  |
| Purchased and internally developed software     | 6,667                           | 7,452                      |
| Furniture and fixtures                          | 1,229                           | 1,242                      |
| Leasehold improvements                          | 1,805                           | 1,809                      |
|   | <b>\$ 23,372</b>                | <b>\$ 26,345</b>           |
| Less: accumulated depreciation and amortization | (17,185)                        | (20,340)                   |
| Property and equipment, net                     | <b>\$ 6,187</b>                 | <b>\$ 6,005</b>            |

(1)

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Includes the original cost and accumulated depreciation of fully-depreciated fixed assets which were \$13.3 million and \$15.8 million at December 31, 2011 and 2012, respectively.



**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The Company has capitalized certain costs of internally developed software for internal use. The estimated useful life of costs capitalized is evaluated for each specific project. Amortization begins in the period in which the software is ready for its intended use. The Company has not capitalized any internally developed software costs during 2010, 2011 and 2012.

Depreciation and amortization expense incurred by the Company was approximately \$3.0 million, \$2.8 million and \$3.2 million for the years ended December 31, 2010, 2011 and 2012, respectively.

**(3) Credit Agreement**

In April 2008, the Company entered into a credit agreement providing for a senior secured \$30 million revolving credit facility ( Credit Agreement ). The Credit Agreement, as amended, matures and all outstanding borrowings are due in April 2014. Interest on outstanding balances under the Credit Agreement will accrue at LIBOR plus an applicable margin rate, as determined under the agreement and has an unused commitment fee. The Credit Agreement contains certain customary representations and warranties, financial covenants, events of default and is secured by substantially all of the assets of the Company. During the years ended December 31, 2011 and 2012, the Company had no borrowings under the Credit Agreement.

**(4) Commitments**

The Company has commitments for future payments related to office facilities leases and other contractual obligations. The Company leases its office facilities under operating lease agreements expiring through 2018. Certain of these lease agreements have free or escalating rent payment provisions or fund certain leasehold improvements which the Company accounts for as a lease incentive. The Company recognizes rent expense under such agreements on a straight-line basis over the lease term with any lease incentive amortized as a reduction of rent expense over the lease term. The Company also has other contractual obligations expiring over varying time periods through 2016. Other contractual obligations primarily relate to minimum contractual payments due to distribution partners and other outside service providers.

Future minimum payments are approximately as follows (in thousands):

|                               | <b>Facilities<br/>operating<br/>leases</b> | <b>Other<br/>contractual<br/>obligations</b> | <b>Total</b>     |
|-------------------------------|--|--|------------------|
| 2013                          | \$ 2,235                                   | \$ 2,836                                     | \$ 5,071         |
| 2014                          | 2,288                                      | 1,582  | 3,870            |
| 2015                          | 2,225                                      | 639  | 2,864            |
| 2016                          | 2,266                                      | 447  | 2,713            |
| 2017                          | 2,333                                      |  | 2,333            |
| 2018 and after                | 577  |  | 577              |
| <b>Total minimum payments</b> | <b>\$ 11,924</b>                           | <b>\$ 5,504</b>                              | <b>\$ 17,428</b> |

In December 2010, the Company entered into an amendment to the lease agreement from June 2009 for additional office space in Seattle, Washington, which commenced in December 2010 and expires in March 2018. During 2010 and 2011, the lessor paid approximately \$779,000 and \$204,000, respectively, towards certain leasehold improvements which the Company accounted for as a lease incentive and is amortizing as a reduction of rent expense over the lease term.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

In May 2010, the Company entered into a lease agreement for office facilities in New York, New York which commenced in the second quarter of 2010 and expires in March 2018.

Rent expense incurred by the Company was approximately \$1.7 million, \$2.1 million and \$2.0 million for the years ended December 31, 2010, 2011 and 2012, respectively.

**(5) Income Taxes**

The components of income (loss) before provision for income taxes consist of the following (in thousands):

|   | Years ended December 31, |          |             |
|---|--------------------------|----------|-------------|
|   | 2010                     | 2011     | 2012        |
| United States                                   | \$ (3,518)               | \$ 5,819 | \$ (18,643) |
| Foreign   | (142)                    | (247)    | 4           |
| Income (loss) before provision for income taxes | \$ (3,660)               | \$ 5,572 | \$ (18,639) |

The provision (benefit) for income taxes for the Company consists of the following (in thousands):

|  | Years ended December 31, |          |           |
|--|--------------------------|----------|-----------|
|  | 2010                     | 2011     | 2012      |
| Current provision (benefit)  |                          |          |           |
| Federal  | \$ (2,168)               | \$ (249) | \$ (94)   |
| State  | 46                       | 16       | 63        |
| Foreign  |                          |          | 2         |
| Deferred provision (benefit)   |                          |          |           |
| Federal  | 2,004                    | 1,895    | 4,155     |
| State  |                          |          |           |
| Tax expense (benefit) of equity adjustment for stock option exercises and restricted stock vesting | (605)                    | 824      | (4,227)   |
| Valuation allowance  |                          |          | 16,400    |
| Other  | 106                      | 127      | 258       |
| Total income tax expense (benefit)   | \$ (617)                 | \$ 2,613 | \$ 16,557 |

Income tax expense (benefit) differed from the amounts computed by applying the U.S. federal income tax rates of 34% for 2010, 2011, and 2012, respectively, to income (loss) before provision for income taxes as a result of the following (in thousands):

|   | Years ended December 31, |          |            |
|---|--------------------------|----------|------------|
|   | 2010                     | 2011     | 2012       |
| Income tax expense (benefit) at U.S. statutory rate | \$ (1,244)               | \$ 1,895 | \$ (6,337) |
| State taxes, net of valuation allowance             | 30                       | 45       | 42         |
| Non-deductible stock compensation                   | 757                      | 645      | 599        |
| Non-deductible goodwill impairment                  |                          |          | 3,833      |

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|   |          |          |           |
|---|----------|----------|-----------|
| Effect of rate change on deferred items                   |          |          | 1,289     |
| Valuation allowance                                       |          |          | 16,400    |
| Effect of non-U.S. operations, net of valuation allowance | 48       | 84       |           |
| Research tax credits                                      | (240)    | (722)    | (242)     |
| Other non-deductible expenses                             | 32       | 666      | 973       |
| Total income tax expense (benefit)                        | \$ (617) | \$ 2,613 | \$ 16,557 |

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below (in thousands):

|   | As of December 31, |           |
|---|--------------------|-----------|
|   | 2011               | 2012      |
| Deferred tax assets:  |                    |           |
| Accrued liabilities not currently deductible                              | \$ 1,842           | \$ 1,685  |
| Intangible assets-excess of financial statement over tax amortization     | 16,461             | 15,333    |
| Goodwill recognized on financial statements in excess of tax amortization | 21,282             | 18,976    |
| Stock-based compensation  | 7,809              | 4,834     |
| Federal net operating losses and AMT credit carryforwards                 | 1,480              | 3,519     |
| State and city net operating loss carryforwards                           | 4,481              | 5,074     |
| Research & experimental tax credit carryforwards                          | 1,302              | 1,478     |
| Other   | 285                | 329       |
| Gross deferred tax assets   | 54,942             | 51,228    |
| Valuation allowance   | (4,579)            | (21,575)  |
| Net deferred tax assets   | 50,363             | 29,653    |
| Deferred tax liabilities:   |                    |           |
| Excess of tax over financial statement depreciation                       | 1,300              | 1,146     |
| Total deferred tax liabilities  | 1,300              | 1,146     |
| Net deferred tax assets   | \$ 49,063          | \$ 28,507 |

The Company recorded approximately \$2.0 million in federal NOL carryforwards in 2012 which will expire in 2032. The Company also has research and development credits of \$1.5 million available to reduce income taxes, if any, which will expire in 2029 through 2031, if not utilized. The 2012 Taxpayer Relief Act was signed into law on January 2, 2013 which extends the research tax credit for two years to December 31, 2013 and is retroactive to January 1, 2012. As a result of the retroactive extension, the Company expects to recognize an estimated tax benefit of approximately \$413,000 for qualifying amounts incurred in 2012. The tax benefit for the 2012 period will be recognized in the period the law was enacted, which is the first quarter of 2013.

The Company has recorded a deferred tax asset for stock-based compensation recorded on unexercised non-qualified stock options and certain restricted shares. The ultimate realization of this asset is dependent upon the fair value of the Company's stock when the options are exercised, and generation of sufficient taxable income to realize the benefit of the related tax deduction.

At December 31, 2011 and 2012, the Company recorded a valuation allowance of \$4.6 million and \$21.6 million, respectively, against its federal, state, city and foreign net deferred tax assets, as it believes it is more likely than not that these benefits will not be realized. The change in the valuation allowance in 2012 was approximately \$17.0 million.

The Company regularly reviews deferred tax assets to assess whether it is more likely than not that the deferred tax assets will be realized and, if necessary, establishes a valuation allowance for portions of such assets to reduce the carrying value. At the end of the fourth quarter of 2012, the Company recognized a partial valuation allowance of \$16.4 million on its federal deferred tax assets. In assessing whether it is more likely than not that the Company's deferred tax assets will be realized, factors considered included: historical taxable income, historical trends related to advertiser usage rates, projected revenues and expenses, macroeconomic conditions, issues facing our industry, existing contracts, our ability to project future results and any appreciation of our



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**MARCHEX, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

other assets. During the fourth quarter of 2012, the Company incurred a \$16.7 million goodwill impairment loss within its Archeo operating segment due in part to lower projected revenue growth rates and profitability levels within Archeo compared to historical results.

The majority of the deferred tax assets have arisen due to deductions taken in the financial statements related to the impairment of goodwill and the amortization of intangible assets recorded in connection with various acquisitions that are tax-deductible over 15 year periods. Consequently, based on projections of future taxable income and tax planning strategies, the Company expects to be able to recover a portion of these assets. Although realization is not assured, the Company believes it is more likely than not, based on its operating performance, existing deferred tax liabilities, projections of future taxable income and tax planning strategies, that the Company's net deferred tax assets, excluding certain state and foreign net operating loss carryforwards, will be realized. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if the Company's projections of future taxable income are reduced or if the Company does not perform at the levels it is projecting. This could result in increases to the valuation allowance for deferred tax assets and a corresponding increase to income tax expense of up to the entire net amount of deferred tax assets.

At December 31, 2011 and 2012, the Company has certain tax effected state, city, and foreign net operating loss (NOL) carryforwards of approximately \$4.6 million and \$5.2 million, respectively. The Company does not have a history of taxable income in the relevant jurisdictions and the state, city, and foreign net operating loss carryforwards will more likely than not expire unutilized. Therefore, the Company has recorded a 100% valuation allowance on the state, city, and foreign net operating loss carryforwards as of December 31, 2011 and 2012.

In connection with the Jingle acquisition in 2011, the Company acquired federal NOL carryforwards. Where there is a change in ownership within the meaning of Section 382 of the Internal Revenue Code, the acquired federal net operating loss carryforwards are subject to an annual limitation. The Company believes that such an ownership change had occurred at Jingle, and that the utilization of the carryforwards is limited such that the majority of the NOL carryforwards will never be available. Accordingly, the Company recorded approximately \$7.0 million of NOL carryforwards, which will begin to expire in 2026. The Company utilized \$2.6 million in 2011.

In addition, at December 31, 2011 and 2012, the Company had certain federal net operating loss carryforwards of approximately \$1.7 million which begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. The Company believes that such a change has occurred related to these specific NOL carryforwards, and that the utilization of the approximately \$1.7 million in carryforwards is limited such that substantially all of these NOL carryforwards will never be utilized. Accordingly, the Company has not included these federal NOL carryforwards in its deferred tax assets.

During the years ended December 31, 2010, 2011 and 2012, the Company recognized excess tax benefits (shortfall) on stock option exercises, restricted stock vesting, and dividends paid on unvested restricted stock of approximately (\$537,000), \$913,000, and (\$4.0) million, respectively, which were recorded to additional paid in capital.

The tax benefit realized for the tax deductions from option exercises and restricted stock vesting totaled \$1.2 million, \$2.5 million, and \$0, respectively, for the years ended December 31, 2010, 2011, and 2012.

From time to time, various state, federal and other jurisdictional tax authorities undertake audits of the Company and its filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for uncertain positions. The Company adjusts these contingencies in light of changing

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

facts and circumstances, such as the outcome of tax audits. Audits of the Company's federal tax returns for 2005 through 2009, comprising approximately \$463,000 of uncertain tax positions, were settled in 2011. Resolution of uncertain tax positions will impact our effective tax rate when settled. The Company does not have any significant interest or penalty accruals. The provision for income taxes includes the impact of contingency provisions and changes to contingencies that are considered appropriate.

The following table summarizes the activity related to the Company's tax contingencies from January 1, 2010 to December 31, 2012 (in thousands):

|  |               |
|--|---------------|
| Gross tax contingencies January 1, 2010                        | \$ 463        |
| Gross increases to tax positions associated with prior periods | \$            |
| Gross increases to current period tax positions                | \$ 83         |
| Gross decreases to tax positions associated with prior periods | \$            |
| Settlements  | \$            |
| Lapse of statute of limitations                                | \$            |
| <b>Gross tax contingencies December 31, 2010</b>               | <b>\$ 546</b> |
| Gross increases to tax positions associated with prior periods | \$ 66         |
| Gross increases to current period tax positions                | \$ 156        |
| Gross decreases to tax positions associated with prior periods | \$ (362)      |
| Settlements  | \$ (101)      |
| Lapse of statute of limitations                                | \$            |
| <b>Gross tax contingencies December 31, 2011</b>               | <b>\$ 305</b> |
| Gross increases to tax positions associated with prior periods | \$ 28         |
| Gross increases to current period tax positions                | \$            |
| Gross decreases to tax positions associated with prior periods | \$ (83)       |
| Settlements  | \$            |
| Lapse of statute of limitations                                | \$            |
| <b>Gross tax contingencies December 31, 2012</b>               | <b>\$ 250</b> |

The Company files U.S. federal, certain U.S. states, and certain foreign tax returns. Generally, U.S. federal, U.S. state, and foreign tax returns filed for years after 2007 are within the statute of limitations and are under examination or may be subject to examination.

**(6) Stockholders' Equity****(a) Common Stock and Authorized Capital**

The authorized capital stock of the Company consisted of 1,000,000 shares of undesignated preferred stock and 125,000,000 shares of Class B common stock. The Company's board of directors has the authority to issue up to 1,000,000 shares of preferred stock, \$0.01 par value in one or more series and has the authority to designate rights, privileges and restrictions of each such series, including dividend rights, dividend rates, conversion rights, voting rights, terms of redemption, redemption prices, liquidation preferences and the number of shares constituting any series.

The Company has two classes of authorized common stock: Class A common stock and Class B common stock. Except with respect to voting rights, the Class A and Class B shares have identical rights. Each share of Class A common stock is entitled to twenty-five votes per share, and each share of Class B common stock is entitled to one vote per share. Each share of Class A common stock is convertible at the holder's option

into one share of Class B common stock.



**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

In accordance with the stockholders' agreement signed by Class A and the founding Class B common stockholders, the following provisions survived the Company's initial public offering: Class A stockholders other than Russell C. Horowitz may only sell, assign or transfer their Class A stock to existing Class A stockholders or to the Company and in the event of transfers of Class A stock not expressly permitted by the stockholders' agreement, such shares of Class A stock shall be converted into shares of Class B common stock.

In November 2006, the Company's board of directors authorized a share repurchase program for the Company to repurchase up to 3 million shares of the Company's Class B common stock as well as the initiation of a quarterly cash dividend for the holders of the Class A and Class B common stock. In 2008 and 2009, the Company's board of directors authorized various increases in the share repurchase program for the Company to repurchase up to 11 million shares in the aggregate (less shares previously repurchased under the share repurchase program) of the Company's Class B common stock. In December 2011, the Company's board of directors authorized an increase in the share repurchase program for the Company to repurchase up to 12 million shares in the aggregate (less shares previously repurchased under the share repurchase program) of the Company's Class B common stock. Under the share repurchase program, repurchases may take place in the open market and in privately negotiated transactions and at times and in such amounts as the Company deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This stock repurchase program does not have an expiration date and may be expanded, limited or terminated at any time without prior notice. During the year ended December 31, 2010, the Company repurchased approximately 1.2 million shares of Class B common stock for \$6.5 million under this repurchase program. During the year ended December 31, 2011, the Company repurchased approximately 883,000 shares of Class B common stock for \$6.2 million under this repurchase program. During the year ended December 31, 2012, the Company repurchased approximately 387,000 shares of Class B common stock for \$1.7 million under this repurchase program.

During the years ended December 31, 2011 and 2012, the Company's board of directors authorized the retirement of 1.0 million and 1.2 million shares, respectively, of the Company's Class B common stock, all of which had been repurchased by the Company and had been classified as treasury stock on the consolidated balance sheet before retirement.

During 2010, 2011 and 2012, the Company's board of directors declared the following quarterly dividends on the Company's Class A common stock and Class B common stock:

| <b>Approval Date</b> | <b>Per share dividend</b> | <b>Date of record</b> | <b>Total amount (in thousands)</b> | <b>Payment date</b> |
|----------------------|---------------------------|-----------------------|------------------------------------|---------------------|
| January 2010         | \$ 0.02                   | February 4, 2010      | \$ 706                             | February 15, 2010   |
| April 2010           | \$ 0.02                   | May 5, 2010           | \$ 704                             | May 17, 2010        |
| July 2010            | \$ 0.02                   | August 6, 2010        | \$ 705                             | August 16, 2010     |
| October 2010         | \$ 0.02                   | November 5, 2010      | \$ 701                             | November 15, 2010   |
| January 2011         | \$ 0.02                   | February 4, 2011      | \$ 712                             | February 15, 2011   |
| April 2011           | \$ 0.02                   | May 6, 2011           | \$ 743                             | May 16, 2011        |
| July 2011            | \$ 0.02                   | August 5, 2011        | \$ 738                             | August 15, 2011     |
| October 2011         | \$ 0.02                   | November 5, 2011      | \$ 745                             | November 15, 2011   |
| January 2012         | \$ 0.02                   | February 3, 2012      | \$ 751                             | February 15, 2012   |
| April 2012           | \$ 0.02                   | May 4, 2012           | \$ 743                             | May 15, 2012        |
| July 2012            | \$ 0.02                   | August 3, 2012        | \$ 755                             | August 15, 2012     |
| August 2012          | \$ 0.015                  | August 16, 2012       | \$ 566                             | August 31, 2012     |
| October 2012         | \$ 0.035                  | November 2, 2012      | \$ 1,300                           | November 15, 2012   |

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**MARCHEX, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

In August 2012, the Company's board of directors approved an increase to the Company's quarterly cash dividend on the Company's Class A and Class B common stock, subject to capital availability, from \$0.02 per share to \$0.035 per share. The increase in the dividend raises the annual dividend rate to \$0.14 per share or \$5.3 million. The Company paid the incremental \$0.015 per share dividends on August 31, 2012 to Class A and Class B common stockholders of record as of the close of business on August 16, 2012. The Company paid approximately \$566,000 for these incremental dividends.

In December 2012, the Company's board of directors declared a quarterly dividend for the first, second, third and fourth quarters of 2013 totaling \$0.14 per share on its Class A common stock and Class B common stock, which was paid on December 31, 2012 to the holders of record as of the close of business on December 18, 2012. The dividend paid totaled \$5.3 million.

***(b) Stock Option Plan***

The Company's stock incentive plan (the 2003 Plan) allows for grants of both stock option and restricted stock awards to employees, officers, non-employee directors, and consultants and such options may be designated as incentive or non-qualified stock options at the discretion of the Plan's Administrative Committee. In May 2010, the Company's Board of Directors approved an amendment to the Company's 2003 Amended and Restated Stock Incentive Plan (the Plan) which provides for the grant of restricted stock units to eligible participants under the Plan. The Plan authorizes grants of options to purchase up to 4,000,000 shares of authorized but unissued Class B common stock and provides for the total number of shares of Class B common stock for which options designated as incentive stock options may be granted shall not exceed 8,000,000 shares. Annual increases are to be added on the first day of each fiscal year beginning on January 1, 2004 equal to 5% of the outstanding common stock (including for this purpose any shares of common stock issuable upon conversion of any outstanding capital stock of the Company). As a result of this provision, the authorized number of shares available under this Plan was increased by 1,768,421 to 15,901,595 on January 1, 2010 and by 1,774,752 to 17,676,347 on January 1, 2011 and by 1,877,411 to 19,553,758 on January 1, 2012. The Company may issue new shares or reissue treasury shares for stock option exercises and restricted stock grants. Generally, stock options have 10-year terms and vest 25% each year either annually or quarterly, over a 4 year period.

In April 2012, the Company's Board of Directors approved the establishment of the Marchex 2012 Stock Incentive Plan (the 2012 Plan). After December 31, 2012, no further awards will be made under the 2003 Plan. The 2012 Plan authorizes up to 3,500,000 shares of Class B common stock that may be issued with respect to awards granted under the Plan, and provides that the total number of shares of Class B common stock for which options designated as incentive stock options may be granted shall not exceed 3,500,000 shares. Annual increases to each of these share limits are to be added on the first day of each fiscal year beginning on January 1, 2013 equal to 5% of the outstanding common stock (including for this purpose any shares of common stock issuable upon conversion of any outstanding capital stock of the Company) or in the case of incentive stock options, if lesser of 2,000,000 shares of Class B common stock or such number as determined by the Company's Board of Directors. As a result of this provision, the authorized number of shares available under the 2012 Plan was increased by 1,877,388 to 5,377,388. The Company may issue new shares or reissue treasury shares for stock option exercises and restricted stock grants. Generally, stock options have 10-year terms and vest 25% each year either annually or quarterly, over a 4 year period.

The Company did not grant any options with exercise prices less than the then current market value during 2010, 2011 and 2012.

The Company measures stock-based compensation cost at the grant date based on the fair value of the award and recognize it as expense, net of estimated forfeitures, over the vesting or service period, as applicable, of the stock award using the straight-line method.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

Stock-based compensation expense has been included in the same lines as compensation paid to the same employees in the consolidated statement of operations. Stock-based compensation expense was included in the following operating expense categories as follows (in thousands):

|  | Twelve months ended December 31, |                  |                  |
|--|----------------------------------|------------------|------------------|
|  | 2010                             | 2011             | 2012             |
| Service costs  | \$ 805                           | \$ 1,291         | \$ 1,904         |
| Sales and marketing  | 799                              | 1,505            | 2,039            |
| Product development  | 1,015                            | 1,416            | 1,051            |
| General and administrative   | 8,213                            | 10,931           | 10,702           |
| <b>Total stock-based compensation</b>  | <b>\$ 10,832</b>                 | <b>\$ 15,143</b> | <b>\$ 15,696</b> |
| Income tax benefit related to stock-based compensation included in net income (loss) | \$ 3,012                         | \$ 5,048         | \$ 4,857         |

FASB ASC 718 requires the benefits of tax deductions in excess of the stock-based compensation cost to be classified as financing cash inflows rather than operating cash inflows. This amount is shown as Excess tax benefit related to stock-based compensation on the consolidated statement of cash flows.

The Company uses the Black-Scholes option pricing model to estimate the per share fair value of stock option grants with time-based vesting. The Black-Scholes model relies on a number of key assumptions to calculate estimated fair values. For years ended December 31, 2010, 2011 and 2012, the expected life of each award granted was determined based on historical experience with similar awards, giving consideration to contractual terms, anticipated exercise patterns, vesting schedules and forfeitures. Expected volatility is based on historical volatility levels of the Company's Class B common stock and the expected volatility of companies in similar industries that have similar vesting and contractual terms. The risk-free interest rate is based on the implied yield currently available on U.S. Treasury issues with terms approximately equal to the expected life of the option. The Company uses an expected annual dividend yield in consideration of the Company's common stock dividend payments which commenced in 2007.

The following weighted average assumptions were used in determining the fair value of time-vested stock option grants for the periods presented:

|                                      | Years ended December 31, |      |                |      |                |      |
|--------------------------------------|--------------------------|------|----------------|------|----------------|------|
|                                      | 2010                     |      | 2011           |      | 2012           |      |
| Expected life (in years)             | 3.5                      | 6.25 | 4.0            | 6.25 | 4.0            | 6.25 |
| Risk-free interest rate              | 1.00% to 2.08%           |      | 0.60% to 1.77% |      | 0.47% to 0.78% |      |
| Expected volatility                  | 66% to 68%               |      | 68% to 71%     |      | 65% to 70%     |      |
| Weighted average expected volatility | 67%                      |      | 70%            |      | 67%            |      |
| Expected dividend yield              | 0.91% to 1.10%           |      | 0.91%          |      | 1.33% to 3.11% |      |

During 2010, 2011, and 2012, the Company issued equity awards which include stock options, restricted stock awards, and restricted stock units that have vesting based on a combination of certain service and market conditions. The compensation costs and derived service periods for stock option grants with vesting based on a combination of service and market conditions are estimated using the binomial lattice model to determine the fair value for each tranche and a Monte Carlo simulation to determine the derived service period for each tranche. The risk-free interest rate is based on the 10 year bond rate as of the valuation date based on the contractual life of the option.



**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The following weighted average assumptions were used in determining the fair value for option grants with vesting based on a combination of certain service and market conditions for the periods presented:

|                                      | Years ended December 31, |     |       |      |       |      |
|--------------------------------------|--------------------------|-----|-------|------|-------|------|
|                                      | 2010                     |     | 2011  |      | 2012  |      |
| Expected life (in years)             | 1.2                      | 5.9 | 1.97  | 4.54 | 1.50  | 5.74 |
| Risk-free interest rate              | 3.36% to 3.56%           |     | 1.94% |      | 1.81% |      |
| Expected volatility                  | 61%                      |     | 57%   |      | 60%   |      |
| Weighted average expected volatility | 61%                      |     | 57%   |      | 60%   |      |
| Expected dividend yield              | 0.91% to 1.63%           |     | 1.26% |      | 3.17% |      |

Stock option and restricted stock award activity during the period indicated is as follows:

|   | Options and Restricted Stock available for grant | Number of options outstanding | Weighted average exercise price of options | Weighted average remaining contractual term (in years) | Aggregate intrinsic value (in thousands) |
|---|--|-------------------------------|--|--|--|
| Balance at December 31, 2009            | 3,478,507  | 4,701,151                     | \$ 9.59                                    | 5.61   |  |
| Increase to option pool January 1, 2010 | 1,768,421  |                               |  |  |  |
| Options granted <sup>(1)</sup>          | (2,376,450)                                      | 2,376,450                     | 6.62                                       |  |  |
| Restricted stock granted                | (1,613,000)                                      |                               |  |  |  |
| Restricted stock forfeited              | 82,250   |                               |  |  |  |
| Options exercised                       |  | (81,974)                      | 4.54                                       |  |  |
| Options expired                         | 296,214  | (296,214)                     | 13.49                                      |  |  |
| Options forfeited                       | 288,824  | (288,824)                     | 7.12                                       |  |  |
| Balance at December 31, 2010            | 1,924,766  | 6,410,589                     | \$ 8.48                                    | 7.20   |  |
| Increase to option pool January 1, 2011 | 1,774,752  |                               |  |  |  |
| Options granted <sup>(2)</sup>          | (1,735,950)                                      | 1,735,950                     | 7.28                                       |  |  |
| Restricted stock granted                | (1,603,899)                                      |                               |  |  |  |
| Restricted stock forfeited              | 62,125   |                               |  |  |  |
| Options exercised                       |  | (410,662)                     | 4.28                                       |  |  |
| Options expired                         | 277,775  | (277,775)                     | 14.47                                      |  |  |
| Options forfeited                       | 254,318  | (254,318)                     | 6.70                                       |  |  |
| Balance at December 31, 2011            | 953,887  | 7,203,784                     | \$ 8.24                                    | 6.81   |  |
| Increase to option pool January 1, 2012 | 1,877,411  |                               |  |  |  |
| Options granted <sup>(2)</sup>          | (915,500)  | 915,500                       | 4.13                                       |  |  |
| Restricted stock granted                | (1,343,250)                                      |                               |  |  |  |
| Restricted stock forfeited              | 723,232  |                               |  |  |  |
| Options exercised                       |  | (6,556)                       | 4.13                                       |  |  |
| Options expired                         | 407,505  | (407,505)                     | 11.04                                      |  |  |
| Options forfeited                       | 675,863  | (675,863)                     | 7.04                                       |  |  |
| Balance at December 31, 2012            | 2,379,148  | 7,029,360                     | \$ 7.67                                    | 6.28   | \$ 506                                   |

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|   |           |         |      |        |
|---|-----------|---------|------|--------|
| Options exercisable at December 31, 2012 <sup>(3)</sup> | 4,650,934 | \$ 8.52 | 5.08 | \$ 339 |
|---|-----------|---------|------|--------|

- (1) Includes 880,000 stock options which vest over 2 years.
- (2) Includes 765,000, 313,400, and 202,000 stock options issued in 2010, 2011 and 2012, respectively, which have vesting based on a combination of certain service and market conditions.
- (3) Includes 618,000 stock options which have vested based on meeting a combination of certain service and market conditions.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The following table summarizes information concerning currently outstanding and exercisable options at December 31, 2012:

| Range of exercise prices per share | Options Outstanding |   |   | Options Exercisable |   |
|------------------------------------|---------------------|---|---|---------------------|---|
|                                    | Number Outstanding  | Average remaining contractual life (in years) | Weighted Average Exercise price per share | Number exercisable  | Weighted average exercise price per share |
| \$ 3.00 \$ 4.06                    | 715,589             | 5.76  | \$ 3.40                                   | 341,610             | \$ 3.12                                   |
| \$ 4.10 \$ 4.41                    | 482,544             | 9.72  | 4.38                                      | 18,610              | 4.28                                      |
| \$ 4.44 \$ 4.63                    | 738,375             | 6.67  | 4.62                                      | 718,149             | 4.63                                      |
| \$ 4.64 \$ 4.89                    | 806,051             | 6.54  | 4.85                                      | 657,986             | 4.86                                      |
| \$ 4.90 \$ 6.10                    | 368,778             | 7.02  | 5.41                                      | 234,677             | 5.43                                      |
| \$ 6.19 \$ 6.35                    | 846,100             | 8.82  | 6.35                                      | 229,025             | 6.35                                      |
| \$ 6.38 \$ 8.67                    | 477,175             | 4.43  | 7.11                                      | 334,715             | 6.88                                      |
| \$ 8.68 \$ 8.77                    | 756,850             | 7.41  | 8.77                                      | 432,949             | 8.77                                      |
| \$ 8.81 \$11.02                    | 873,062             | 5.12  | 10.27                                     | 718,377             | 10.45                                     |
| \$11.27 \$24.54                    | 964,836             | 3.00  | 16.21                                     | 964,836             | 16.21                                     |
|                                    | 7,029,360           | 6.28  | \$ 7.67                                   | 4,650,934           | \$ 8.52                                   |

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

|   | Years ended December 31, |          |           |
|---|--------------------------|----------|-----------|
|   | 2010                     | 2011     | 2012      |
| Weighted average fair value of options granted                        | \$ 6.62                  | \$ 3.54  | \$ 1.78   |
| Intrinsic value of options exercised (in thousands)                   | \$ 293                   | \$ 1,885 | \$ 7      |
| Total grant date fair value of restricted stock vested (in thousands) | \$ 5,023                 | \$ 4,056 | \$ 22,015 |

At December 31, 2012, there was \$6.6 million of stock option compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 2.5 years.

During the years ended December 31, 2010, 2011 and 2012 gross proceeds recognized from the exercise of stock options was approximately \$372,000, \$1.8 million and \$27,000, respectively. The net excess tax benefit (shortfall) on stock option exercises, restricted stock vesting, and dividends paid on unvested restricted stock during the years ended December 31, 2010, 2011 and 2012, of approximately (\$537,000), \$913,000 and (\$4.0) million, respectively, were recorded to additional paid in capital.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

Restricted stock awards and restricted stock unit activity for the years ended December 31, 2010, 2011 and 2012 is summarized as follows:

|                               | Shares/<br>Units | Weighted Average<br>Grant Date<br>Fair Value |
|-------------------------------|------------------|--|
| Unvested at December 31, 2009 | 2,541,802        | \$ 8.99                                      |
| Granted                       | 1,613,000        | 6.67   |
| Vested                        | (603,802)        | 8.32   |
| Forfeited                     | (82,250)         | 4.52   |
| Unvested at December 31, 2010 | 3,468,750        | \$ 8.13                                      |
| Granted <sup>(1)</sup>        | 1,603,899        | 7.20   |
| Vested                        | (721,500)        | 5.63   |
| Forfeited                     | (62,125)         | 6.42   |
| Unvested at December 31, 2011 | 4,289,024        | \$ 8.23                                      |
| Granted <sup>(2)</sup>        | 1,343,250        | 3.79   |
| Vested                        | (2,323,431)      | 9.47   |
| Forfeited                     | (745,332)        | 7.08   |
| Unvested at December 31, 2012 | 2,563,511        | \$ 5.12                                      |

(1) Includes 255,000 and 104,100 restricted stock units issued in 2010 and 2011, respectively, which entitle the holder to receive one share of the Company's Class B common stock upon satisfaction of certain service and market conditions.

(2) Includes 202,000 restricted stock awards issued in 2012, which vest upon satisfaction of certain service and market conditions.

The Company issues restricted stock to employees for future services and in connection with acquisitions. Restricted stock awards grants are generally measured at fair value on the date of grant based on the number of awards granted and the quoted price of the Company's common stock. Restricted shares issued are accounted for under FASB ASC 718 using the straight-line method net of estimated forfeitures.

As of December 31, 2012, there was \$13.3 million of total restricted stock compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 2.6 years.

In the second quarter of 2012, vesting of approximately 195,000 restricted shares were fully accelerated in connection with a separation agreement. In the fourth quarter of 2012, 1,050,000 restricted shares that would otherwise have vested on January 1, 2013 were vested on December 31, 2012.

During 2012, the Company repurchased 391,000 shares from certain executives for minimum withholding taxes on 1,255,000 restricted stock award vests. The number of shares repurchased was based on the value on the vesting date of the restricted stock awards equivalent to the value of the executives' minimum withholding taxes of \$1.6 million. The Company then remitted cash to the appropriate taxing authorities. The payments are reflected as a financing activity within the consolidated statement of cash flows when paid. The payments had the effect of share repurchases by the Company as they reduced the number of shares that would have otherwise been issued on the vesting date and were recorded as a reduction of additional paid in capital.



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**MARCHEX, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

***(c) Employee Stock Purchase Plan***

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

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

In December 2005, the compensation committee of the Company's board of directors amended the 2004 Employee Stock Purchase Plan to provide that effective January 1, 2006 eligible participants may purchase the Company's Class B common stock under the purchase plan at a price equal to 95% of the fair value on the last day of an offering period. During the year ended December 31, 2010, 3,304 shares were purchased at prices ranging from \$3.66 to \$9.06 per share. During the year ended December 31, 2011, 3,637 shares were purchased at prices ranging from \$5.94 to \$8.44 per share. During the year ended December 31, 2012, 9,817 shares were purchased at prices ranging from \$3.43 to \$4.24 per share. At December 31, 2012, approximately 214,000 shares were available under the purchase plan for future issuance.

***(7) Contingencies***

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

In some agreements to which we are a party, we have agreed to indemnification provisions of varying scope and terms with advertisers, vendors and other parties with respect to certain matters, including, but not limited to, losses arising out of the Company's breach of agreements or representations and warranties made by the Company, services to be provided by the Company and intellectual property infringement claims made by third parties. As a result of these provisions, we may from time to time provide certain levels of financial support to our contract parties to seek to minimize the impact of any associated litigation in which they may be involved. To date, there have been no known events or circumstances that have resulted in any material costs related to these indemnification provisions and no liabilities therefore have been recorded in the accompanying consolidated financial statements. However, the maximum potential amount of the future payments we could be required to make under these indemnification provisions could be material.

***(8) 401(k) Savings Plan***

The Company has a Retirement/Savings Plan (401(k) Plan) under Section 401(k) of the Internal Revenue Code which covers those employees that meet eligibility requirements. Eligible employees may contribute up to the Internal Revenue Code prescribed maximum amounts. During 2011, the Company elected to match a portion of the employee contributions up to a defined maximum. No cash matching contributions were made in 2011. In 2012, cash contributions were made in the amount of \$67,000.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****(9) Acquisition**

On April 7, 2011, the Company acquired 100% of the stock of Jingle, a provider of mobile voice search performance advertising and technology solutions in North America for the following consideration:

Approximately \$15.8 million in cash, net of cash acquired, and 1,019,103 shares of the Company's Class B common stock paid at closing; and

Future consideration of (i) \$17.6 million, net of certain working capital adjustments, on the first annual anniversary of the closing, and (ii) \$18.0 million on the 18th month anniversary of closing, with the future consideration payable in either cash or shares of the Company's Class B common stock or some combination to be determined by the Company. Any shares issued in payment of the future consideration will be increased by 5%. In April 2012 and October 2012, the Company paid approximately \$16.9 million and \$17.9 million in cash, net of certain working capital and other adjustments, on the first and 18th month anniversary of closing, respectively.

Following the closing, the Company issued 462,247 shares of restricted stock at an aggregate value of approximately \$3.3 million to employees of Jingle, subject to vesting for up to four years.

The Company accounted for the Jingle acquisition as a business combination. As a result of the acquisition, the Company added additional sources of mobile distribution to its call advertising network. The Company has progressed in its integration of Jingle's operations, including sales activities, and accordingly, revenues and earnings of the acquired operations are not readily separable.

The fair value of the shares of Class B common stock issued as part of the consideration paid was valued at \$7.6 million using the Company's closing stock price of \$7.46 per share at the acquisition date. The fair value of the future consideration payments of \$34.7 million was discounted using a rate of approximately 2% based on the Company's incremental borrowing rate and is recorded on the balance sheet as deferred acquisition payments. Acquisition related costs of approximately \$1.9 million for 2011 were primarily for professional fees to perform due diligence, historical audits and other procedures associated with the acquisition. Of the \$1.9 million of acquisition related costs in 2011, we recognized approximately \$372,000 for the future obligations of non-cancelable lease and other costs related to the Jingle office. The portion related to the non-cancelable lease is based on estimates of vacancy period and sublease income. In March 2012, the Company arranged for the future sublease of the Jingle office space and revised its original estimates which resulted in a \$132,000 benefit recorded in acquisition and separation related costs in the consolidated statements of operations. The actual vacancy periods may differ from these estimates, and sublease income, if any, may not materialize. Accordingly, these estimates may be adjusted in future periods.

In connection with the acquisition, the Company acquired federal net operating loss carryforwards ( NOL ). Where there is a change in ownership within the meaning of Section 382 of the Internal Revenue Code, the acquired federal net operating loss carryforwards are subject to an annual limitation. The Company believes that such an ownership change had occurred at Jingle, and that the utilization of the carryforwards is limited such that the majority of the NOL carryforwards will never be utilized. Accordingly, the Company recorded approximately \$7.0 million of NOL carryforwards. In 2011, the Company utilized approximately \$2.6 million.

A summary of the consideration for the acquisition is as follows (in thousands):

|                      |           |
|----------------------|-----------|
| Cash                 | \$ 16,563 |
| Stock issued         | 7,603     |
| Future consideration | 34,695    |

Total

\$ 58,861

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