GLATFELTER P H CO
Form 10-K
February 26, 2016
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

þ **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2015

or

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from to

96 South George Street, Suite 520

York, Pennsylvania 17401

(Address of principal executive offices)

(717) 225-4711

(Registrant s telephone number, including area code)

Commission file number	Exact name of registrant as specified in its charter	IRS Employer Identification No.	State or other jurisdiction of incorporation or organization
1-03560	**P. H. Glatfelter Company**	**23-0628360**	**Pennsylvania**

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

Title of Each Class	Name of Each Exchange on which registered
Common Stock, par value $.01 per share	**New York Stock Exchange**

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

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 þ.

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

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 þ 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 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 small reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. þ Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Small reporting company (Do not check if a smaller reporting company).

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

Based on the closing price as of June 30, 2015, the aggregate market value of the Common Stock of the Registrant held by non-affiliates was $940.3 million.

Common Stock outstanding on February 23, 2016 totaled 43,442,171 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated by reference in this Annual Report on Form 10-K:

Portions of the registrant s Proxy Statement to be dated on or about March 31, 2016 are incorporated by reference into Part III.

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P. H. GLATFELTER COMPANY

ANNUAL REPORT ON FORM 10-K

For the Year Ended

DECEMBER 31, 2015

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PART I

P. H. Glatfelter Company makes regular filings with the Securities and Exchange Commission (SEC), including this Annual Report on Form 10-K, as well as Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. These filings are available, free of charge, on our website, www.glatfelter.com, and the SEC s website at www.sec.gov. We also provide copies of our SEC filings at no charge upon request to Investor Relations at (717) 225-2719, ir@glatfelter.com, or by mail to Investor Relations, 96 South George Street, Suite 520, York, PA, 17401. In this filing, unless the context indicates otherwise, the terms we, us, our, the Company, or Glatfelter refer to P. H. Glatfelter Company and subsidiaries.

ITEM 1 BUSINESS

Overview Glatfelter began operations in 1864, and we believe we are one of the world s leading manufacturers of specialty papers and fiber-based engineered materials. Headquartered in York, Pennsylvania, we own and operate manufacturing facilities in Pennsylvania, Ohio, Canada, Germany, the United Kingdom, France, and the Philippines and we have sales and distribution offices in Russia and China.

Acquisitions Over the past several years, we have completed a number of acquisitions that have diversified our revenue, expanded our geographic footprint and enhanced our asset base. The most recent transactions include the April 2013, $211 million acquisition of Dresden Papier GmbH (Dresden) and the October 2014, $8.0 million acquisition of Spezialpapierfabrik Oberschmitten GmbH (SPO). Dresden is a leading supplier of nonwoven wall covering products with annual revenues of approximately $160 million in the year of acquisition. SPO is a producer of highly technical papers for a wide range of electrical applications with annual sales of approximately $33 million. Both of these businesses operate within our Composite Fibers business unit.

Products Our three business units manufacture and distribute a wide array of specialty papers and fiber-based engineered materials including:

- *Composite Fibers* with revenue from the sale of single-serve tea and coffee filtration papers, nonwoven wall covering materials, metallized papers, composite laminates papers, and many technically special papers including substrates for electrical applications;
- *Advanced Airlaid Materials* with revenue from the sale of airlaid nonwoven fabric-like materials used in feminine hygiene and adult incontinence products, wipes, and other airlaid applications; and
- *Specialty Papers* with revenue from the sale of papers for carbonless and other forms, envelopes, book publishing, and engineered products such as papers for high-speed ink jet printing, office specialty products, greeting cards, packaging, casting, release, transfer, playing card, postal, FDA-compliant food and beverage applications, and other niche specialty applications.

The global growth markets served by the Composite Fibers and Advanced Airlaid Materials business units are characterized by attractive growth rates as the result of emerging products and markets, changing end-user preferences and evolving demographics. Specialty Papers serves more mature market segments, many of which are in decline.

As a result of our strategy to diversify sources of revenue and invest in growth businesses, revenue generated from Composite Fibers and Advanced Airlaid Materials is expected to represent an increasingly greater proportion of total revenue. Combined, these two business units comprised 47% of our total net sales in 2015 compared with 30% in 2006.

Consolidated net sales and the relative net sales contribution of each of our business units for the past three years are summarized below:

Dollars in thousands	**2015**	2014	2013
Net sales	**$ 1,661,084**	$ 1,802,415	$ 1,722,615
Business unit contribution			
Composite Fibers	**32.6%**	34.3%	32.9%
Advanced Airlaid Materials	**14.7**	15.6	15.6
Specialty Papers	**52.7**	50.1	51.5

Total	**100.0%**	100.0%	100.0%

Strategy Our strategy is focused on growing revenues, organically and by acquisition, in our key global growth markets including single-serve coffee and tea, nonwoven wall covering materials, electrical products, hygiene and wipes products, and other technical materials. We partner with leading consumer product companies and other market leaders to provide innovative products with outstanding performance to meet market requirements. Over the past several years, we have made investments to increase production capacity and improve our technical capabilities to ensure we are best positioned to serve the

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market demands and grow our revenue. This includes a $50 million investment in 2013 to expand capacity and improve inclined wire paper machine capabilities in Composite Fibers. We are committed to growing in our key markets and expect to make additional investments to support our customers and satisfy market demands. Consistent with this strategy, in December 2015, we announced plans to invest approximately $80 million to build a new advanced airlaid facility in the southern U.S. to service the North America market. Production at the new facility is expected to start in two years with an annual capacity of approximately 22,000 short tons, increasing our total global airlaid materials capacity to approximately 129,000 short tons.

New product development and new business development is a critical component of our business strategy requiring a focus on product innovation. During 2015, 2014 and 2013, we invested $10.4 million, $12.3 million and $12.2 million, respectively, in new product development activities. In each of the past three years, in excess of 50% of net sales were generated from products developed, enhanced or improved within the past five years.

In addition, our business strategy includes expanding product margins driven by cost reduction and continuous improvement initiatives, generating strong and reliable free cash flows and making strategic investments designed to improve our returns on invested capital.

And finally, the strength of our balance sheet and cash flow profile has allowed us to pursue strategic actions such as the Dresden and SPO acquisitions. Our acquisition strategy complements our long-term strategy of driving growth in core and adjacent markets. Since 2006, we have successfully completed six acquisitions demonstrating our ability to establish leading market positions through the successful acquisition and integration of complementary businesses.

Our Business Units We manage our company as three distinct business units: Composite Fibers; Advanced Airlaid Materials; and Specialty Papers. Net tons sold by each business unit for the past three years were as follows:

Short tons	**2015**	2014	2013
Composite Fibers	**153,766**	157,336	133,570
Advanced Airlaid Materials	**95,957**	99,667	96,098
Specialty Papers	**802,188**	802,878	800,151
Total	**1,051,911**	1,059,881	1,029,819

Composite Fibers Our Composite Fibers business unit serves customers globally and focuses on higher value-added products in the following markets:

- **Food & Beverage** paper primarily used for single-serve coffee and tea products;
- **Wallcovering** base materials used by the world s largest wallpaper manufacturers;
- **Metallized** products used in the labeling of bottles, self-adhesive labels, packaging liners, gift wrap, and other consumer product applications;
- **Composite Laminates** paper used in production of decorative laminates, furniture, and flooring applications; and
- **Technical Specialties** a diverse line of special paper products used in electrical energy storage, transport, and transmission including batteries and capacitors, wipes and other home and hygiene products, and other highly-engineered fiber-based applications.

We believe this business unit maintains a market leadership position in the single-serve coffee and tea markets and nonwoven wallpaper materials markets. Composite Fibers revenue composition by market consisted of the following for the years indicated:

In thousands	**2015**	2014	2013
Food & beverage	**$ 274,865**	$ 296,304	$ 302,738
Wallcovering	**91,620**	149,957	97,698
Metallized	**68,397**	80,839	83,949
Composite laminates	**34,897**	38,159	39,296
Technical specialties and other	**71,689**	52,592	42,679
Total	**$ 541,468**	$ 617,851	$ 566,360

A significant portion of this business unit s revenue is transacted in currencies other than the U.S. dollar and therefore the comparison from period to period reflects the impact of changes in currency exchange rates. Changes in exchange rates unfavorably affected the comparison of 2015 to 2014 by $75.8 million.

We believe many of the markets served by Composite Fibers present attractive growth opportunities by capitalizing on evolving consumer preferences, expanding into new or emerging geographic markets, and by gaining market share through superior products and quality. Many of this business papers are technically sophisticated, require specialized fibers, and many are extremely lightweight, requiring specifically designed papermaking equipment and production processes. Our proven

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capability to produce these demanding products and our customer orientation positions us well to compete in these global markets.

During 2013, we completed the acquisition of Dresden, a leading global supplier of nonwoven wallpaper base materials. The Dresden acquisition added another industry-leading nonwovens product line to our Composite Fibers business, and broadened our relationship with leading producers of consumer and industrial products. Dresden produces products with superior performance and characteristics such as dry strip-ability, higher tear resistance, and no material shrinkage or expansion when wet. However, since late 2014, demand for and pricing of Dresden s products has been adversely impacted by the geopolitical and economic conditions in Russia and Ukraine, countries from which Dresden generates a significant portion of its revenue.

The primary raw materials used in the production of our lightweight papers are abaca pulp, wood pulp and synthetic fibers. Abaca pulp is a specialized pulp with limited sources of availability. Sufficient quantities of abaca pulp and its source fiber are required to support growth in this business unit. Our abaca pulp production process, fulfilled by our Philippine mill, provides a unique advantage to our Composite Fibers business unit. In the event the supply of abaca fiber becomes constrained or when production demands exceed the capacity of the Philippines mill, alternative sources and/or substitute fibers are used to meet customer demands.

The Composite Fibers business unit is comprised of four paper making facilities (Germany, France and England), a nonwoven wall cover base mill (Germany), metallizing operations (Wales and Germany) and a pulp mill (the Philippines). The combined attributes of the facilities are summarized as follows:

Production Capacity (short tons)	Principal Raw Material (PRM)	Estimated Annual Quantity of PRM (short tons)
154,000 lightweight and other	Abaca pulp	17,300
	Wood pulp	95,000
	Synthetic fiber	22,000
28,000 metallized	Base stock	28,000
18,000 abaca pulp	Abaca fiber	27,000

Composite Fibers lightweight products are produced using highly specialized inclined wire paper machine technology and we believe we currently maintain approximately 25% of the global inclined wire capacity.

In addition to critical raw materials, the cost to produce Composite Fibers products is influenced by energy. Although the business unit generates all of its steam needed for production, in 2015, it purchased 75% of its electricity.

In Composite Fibers markets, competition is product line specific as the necessity for technical expertise and specialized manufacturing equipment limits the number of companies offering multiple product lines. The following chart summarizes key competitors by market segment:

Market segment	Competitor
Single serve coffee & tea	Ahlstrom, Purico, MB Papeles and Zhejiang Kan
Nonwoven wallcovering	Ahlstrom, Technocell, Neu Kaliss, and Goznak
Composite laminates	Schweitzer-Maudit, Purico, MB Papeles and Oi Feng
Metallized	AR Metallizing, Torras Papel Novelis, Vaassen, Galileo Nanotech, and Wenzhou Protec Vacuum Metallizing Co.

Our strategy in Composite Fibers is focused on:

- capitalizing on growing global markets in food & beverage, electrical products and dispersible wipes;

- maximizing capacity utilization provided by the investment in state-of-the-art inclined wire technology to support consistent growth of key markets;

- enhancing product mix across all markets by utilizing new product and new business development capabilities;
- implementing continuous improvement methodologies to increase productivity, reduce costs and expand capacity; and
- ensuring readily available access to specialized raw material requirements to support projected growth.

As part of our commitment to realizing the growth potential of certain of this business unit s markets, in 2013 we completed a $50 million investment to expand our inclined wire capacity by nearly 20%, or approximately 10,500 short tons. In addition, the 2014 acquisition of SPO furthers our strategy of capitalizing on the fast-growing electrical market by broadening our electrical papers platform and know-how.

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Advanced Airlaid Materials Our Advanced Airlaid Materials business unit is a leading global supplier of highly absorbent cellulose-based airlaid nonwoven materials primarily used to manufacture consumer products for growing global end-user markets. These products include:

- feminine hygiene;
- specialty wipes;
- adult incontinence;
- home care;
- table top; and
- food pads.

Advanced Airlaid Materials serves customers who are industry leading consumer product companies as well as private-label converters for feminine hygiene, adult incontinence and specialty wipes products. We believe this business unit holds leading market share positions in many of the markets it serves. Advanced Airlaid Materials has developed long-term customer relationships through superior quality, customer service, and a reputation for quickly bringing product and process innovations to market.

Advanced Airlaid Materials revenue composition by market consisted of the following for the years indicated:

In thousands	**2015**	2014	2013
Feminine hygiene	**$ 182,048**	$ 216,836	$ 219,222
Wipes	**22,950**	16,002	15,186
Adult incontinence	**10,720**	17,586	5,046
Home care	**13,345**	15,401	14,857
Other	**15,526**	15,848	14,085
Total	**$ 244,589**	$ 281,673	$ 268,396

A significant portion of this business unit s revenue is transacted in currencies other than the U.S. dollar and therefore the comparison from period to period reflects the impact of changes in currency exchange rates. Changes in exchange rates unfavorably affected the comparison of 2015 to 2014 by $25.1 million.

The feminine hygiene category accounted for 74% of Advanced Airlaid Material s revenue in 2015. The majority of sales of this product are to a small group of large, leading global consumer products companies. These markets are considered to be more growth oriented due to population growth in certain geographic regions and changing consumer preferences. In developing regions, demand is also influenced by increases in disposable income and cultural preferences. The airlaid wipes market

presents attractive growth opportunities and as a result, we are investing approximately $80 million over the next two years to build a new advanced airlaid facility in the United States.

The Advanced Airlaid Materials business unit operates state-of-the-art facilities in Falkenhagen, Germany and Gatineau, Canada. The Falkenhagen location operates three multi-bonded production lines and three proprietary single-lane festooners. The Gatineau location consists of two airlaid production lines employing multi-bonded and thermal-bonded airlaid technologies and two proprietary single-lane festooners.

The business unit s two facilities operate with the following combined attributes:

Airlaid Production Capacity (short tons)	Principal Raw Material (PRM)	Estimated Annual Quantity of PRM (short tons)
107,000	Fluff pulp	75,000

In addition to the cost of critical raw materials, production cost is impacted by energy. Advanced Airlaid Materials purchases substantially all of the electricity and natural gas used in its operations. Approximately 90% of this business unit s revenue is earned under contracts with pass-through provisions directly related to the price of key raw material costs.

Advanced Airlaid Materials continues to be a technology and product innovation leader in technically demanding segments of the airlaid market, most notably feminine hygiene. This business unit s airlaid material production employs multi-bonded and thermal-bonded airlaid technologies as opposed to other methods such as hydrogen-bonding. We believe that its facilities are among the most modern and flexible airlaid facilities in the world, allowing it to produce at industry leading operating rates. Its proprietary single-lane festooning technology provides converting and product packaging which supports efficiency optimization by the customers converting processes. This business unit s in-house technical expertise, combined with significant capital investment requirements and rigorous customer expectations creates large barriers to entry for new competitors.

The following summarizes this business unit s key competitors:

Market segment	Competitor
Airlaid products	Georgia-Pacific LLC, Fitesa, McAirlaid s GmbH, Domtar

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The global markets served by this business unit are characterized by attractive growth opportunities. To take advantage of this, our strategy is focused on:

- maintaining and expanding relationships with customers that are market-leading consumer product companies as well as companies distributing through private label arrangements;
- capitalizing on our product and process innovation capabilities;
- expanding geographic reach of markets served;
- optimizing the use of existing production capacity; and
- employing continuous improvement methodologies and initiatives to reduce costs, improve efficiencies and create additional capacity.

Specialty Papers Our North America-based Specialty Papers business unit focuses on producing papers for the following markets:

- **Carbonless & non-carbonless forms** papers for credit card receipts, multi-part forms, security papers and other end-user applications;
- **Engineered products** for high speed ink jet printing, office specialty products, greeting cards, and other niche specialty applications;
- **Envelope and converting** papers primarily utilized for transactional and direct mail envelopes; and
- **Book publishing** papers for the production of high-quality hardbound books and other book publishing needs.

This business unit produces both commodity products and higher-value-added specialty products. Specialty Papers revenue composition by market consisted of the following for the years indicated:

In thousands	**2015**	2014	2013
Carbonless & forms	**$ 349,831**	$ 376,959	$ 369,618
Engineered products	**190,943**	194,189	184,913
Envelope & converting	**178,067**	183,194	175,928
Book publishing	**152,647**	144,744	153,054
Other	**3,538**	3,805	4,346
Total	**$ 875,026**	$ 902,891	$ 887,859

Many of the market segments served by Specialty Papers are characterized by declining demand resulting in excess capacity, lower operating rates and pricing pressure. As a result, over the past several years, certain producers have closed, reduced or repurposed production capacity in an attempt to bring supply balance to the market. In addition, foreign producers have created additional imbalance by shipping product to the U.S. when market pricing is favorable or the U.S. dollar is stronger. Maintaining the supply and demand balance will require the industry to continually remove capacity sufficient to match declining demand.

Despite our exposure to declining markets, in each of the past eleven years, we have outperformed the broader uncoated free sheet market in terms of shipping volume. We have been successful at maintaining this business unit s shipments by leveraging the flexibility of our asset base to respond to new product and new business development opportunities, efficiently responding to changing customer demands and delivering superior customer service.

We are one of the leading suppliers of carbonless and book publishing papers in the United States. Although the markets for these products are declining, we have been successful in executing our strategy to replace this lost volume with products such as envelope papers, business forms, and other value-added specialty engineered products. Specialty Papers envelope papers market is also declining, however we have leveraged our customer service capabilities and geographic locations to grow our market share in each of the last several years.

Specialty Papers highly technical engineered products include high speed ink jet printing products, office specialty products, greeting cards, packaging, casting, release, transfer, playing card, postal, FDA-compliant food and other niche specialty applications. Such products comprise an array of distinct business niches that are in a continuous state of evolution. Many of these products are utilized for demanding, specialized customer and end-user applications. Some of our products are new and higher growth while others are more mature and further along in the product life cycle. Because many of these products are technically complex and involve substantial customer-supplier development collaboration, they typically command higher per ton prices and generally exhibit greater pricing stability relative to commodity grade paper products.

The Specialty Papers business unit operates two integrated pulp and paper making facilities with the following combined attributes:

Uncoated Production Capacity (short tons)	Principal Raw Material (PRM)	Estimated Annual Quantity of PRM (short tons)
820,000	Pulpwood	2,327,250
	Wood-and other pulps	708,000

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This business unit s pulp mills have a combined pulp making capacity of 615,000 tons of bleached pulp per year. The principal raw material used to produce pulp is pulpwood, including both hardwoods and softwoods. Pulpwood is obtained from a variety of locations including the states of Pennsylvania, Maryland, Delaware, New Jersey, New York, West Virginia, Virginia, Kentucky, Ohio and Tennessee. To protect our sources of pulpwood, we actively promote conservation and forest management among suppliers and woodland owners.

The Spring Grove facility includes five uncoated paper machines as well as an off-line combi-blade coater and a Specialty Coater which together provide annual production capacity for coated paper of approximately 65,000 tons. The Chillicothe facility operates four paper machines producing uncoated and carbonless paper. Two of the machines have built-in coating capability which along with three additional coaters at the facility provide annual coated capacity of approximately 126,000 tons.

In addition to critical raw materials, the cost to produce Specialty Papers products is influenced by energy. Although the business unit generates all of its steam needed for production at both facilities and generates more power than it consumes at the Spring Grove, PA facility, it purchased approximately 25% of its electricity needed for the Chillicothe, OH mill in 2015. The facilities source of fuel is primarily coal and, to a lesser extent, natural gas. As discussed more fully under Environmental Matters, in order to comply with new air quality regulations, we will be implementing modifications that will convert certain boilers to burn natural gas rather than coal. As a result, the consumption of natural gas will increase significantly in late 2016 and beyond.

In Specialty Papers markets, competition is product line specific due to the necessity for technical expertise and specialized manufacturing for certain products. The following chart summarizes key competitors by market segment:

Market segment	Competitor
Carbonless paper	Appvion, Inc., and to a lesser extent, Fibria Celulose, Koehler Paper, Mitsubishi Paper, Nekoosa Coated Products and Asia Pulp and Paper Co.
Engineered products	Specialty papers divisions of International Paper, Domtar Corp., Packaging Corp, and Sappi Limited, among others.
Envelope & converting	Domtar and International Paper
Book publishing	Domtar Corp., North Pacific Paper (NORPAC), Resolute Forest and others

Customer service, product performance, technological advances and product pricing are important competitive factors with respect to all our products. We believe our reputation in these areas continues to be excellent.

To be successful in the market environment in which Specialty Papers operates, our strategy is focused on:

- new product and new business development capabilities to ensure optimal utilization of our capacity and to maximize margins;
- leveraging our flexible operating platform to optimize product mix by shifting production among the machines in our system to more closely match output with changing demand trends;
- utilizing ongoing continuous improvement methodologies to ensure operational efficiencies and asset reliability; and
- maintaining superior customer service.

Additional financial information for each of our business units is included in Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations and in Item 8 Financial Statements and Supplementary Data, Note 24 including geographic revenue and long-lived asset financial information.

Concentration of Customers For each of the past three years, no single customer represented more than 10% of our consolidated net sales. However, as discussed in Item 1A Risk Factors, one customer accounted for the majority of Advanced Airlaid Materials net sales in 2015, 2014 and 2013.

Capital Expenditures Our business is capital intensive and requires significant expenditures for new and enhanced equipment. These capital investments are necessary to support growth strategies, research and development initiatives, environmental compliance, and for normal upgrades or replacements. Capital expenditures totaled $99.9 million, $66.0 million and $103.0 million, in 2015, 2014 and 2013, respectively. For 2016, capital expenditures are estimated as follows:

In millions		
Normal capital expenditures	$ 70	$ 80
Major Projects		
AMBU capacity expansion	40	45
SPBU environmental compliance	40	45
Total	$ 150	$ 170

Environmental Matters We are subject to various federal, state and local laws and regulations intended to protect the environment as well as human health and safety. At various times, we have incurred significant costs to comply with these regulations and we could incur additional costs as new regulations are developed or regulatory priorities change.

We have incurred and will incur additional material capital costs to comply with upcoming air quality regulations including the U.S. EPA Best Available Retrofit Technology rule (BART; otherwise known as the Regional Haze Rule) and the Boiler Maximum Achievable Control Technology rule (Boiler MACT). These rules require process modifications and/or upgrades of air pollution controls on boilers at two of our facilities. We have begun converting or replacing five coal-fired boilers to natural gas and upgrading site infrastructure to accommodate the new boilers, including connecting to gas supply. The total cost of these projects is estimated at $85 million to $90 million, of which $33.0 million has been incurred through the end of 2015. The balance of the related spending should be substantially completed in 2016.

We are a defendant in the Fox River environmental matter. Although this matter is the subject of extensive and ongoing litigation, during 2015, we spent $9.7 million for remediation activities, and possibly may spend a similar amount in 2016. For a more complete discussion of this matter, see Item 8 Financial Statements and Supplementary Data Note 23.

Employees As of December 31, 2015, we employed 4,375 people worldwide, of which approximately 75% are unionized. The United Steelworkers International Union and the Office and Professional Employees International Union represents 1,446 hourly employees at our Chillicothe, OH and Spring Grove, PA facilities under labor contracts expiring in August 2016 for Chillicothe and January 2017 for Spring Grove. Hourly employees at each of our international locations are represented by various unions or works councils. We consider the overall relationship with our employees to be satisfactory.

Other Available Information The Corporate Governance page of our website includes the Company s Governance Principles, Code of Business Conduct, and biographies of our Board of Directors and Executive Officers. In addition, the website includes charters of the Audit, Compensation, Finance, and Nominating and Corporate Governance Committees of the Board of Directors. The Corporate Governance page also includes the Code of Business Ethics for the CEO and Senior Financial Officers of Glatfelter, our whistle-blower policy and other related material. We satisfy the disclosure requirement for any future amendments to, or waivers

from, our Code of Business Conduct or Code of Business Ethics for the CEO and Senior Financial Officers by posting such information on our website. We will provide a copy of the Code of Business Conduct or Code of Business Ethics for the CEO and Senior Financial Officers, without charge, to any person who requests one, by contacting Investor Relations at (717) 225-2719, ir@glatfelter.com or by mail to 96 South George Street, Suite 520, York, PA, 17401.

ITEM 1A RISK FACTORS

Our business and financial performance may be adversely affected by a weak global economic environment or downturns in the target markets that we serve.

Adverse global economic conditions could impact our target markets resulting in decreased demand for our products. Our results could be adversely affected if economic conditions weaken or fail to improve. In the event of significant currency weakening in the countries into which our products are sold, demand for or pricing of our products could be adversely impacted. Also, there may be periods during which demand for our products is insufficient to enable us to operate our production facilities in an economical manner. As a result, we may be forced to take machine downtime. The economic environment may also cause customer insolvencies which may result in their inability to satisfy their financial obligations to us. These conditions are beyond our control and may have a significant impact on our sales and results of operations.

Approximately $75 million of our revenue in 2015 was earned from customers located in Ukraine, Russia and members of the Commonwealth of Independent States (also known as CIS). Uncertain geo-political and economic conditions in this region and weak currencies have and may continue to cause weak demand for our products as well as volatility in our customers buying patterns.

Approximately 28% of our net sales in 2015 were shipped to customers in Europe, the demand for which is dependent on economic conditions in this area, or to the extent such customers do business outside of Europe, in other regions of the world. Uncertain economic conditions in this region may cause weakness in demand for our products as well as volatility in our customers buying patterns.

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Foreign currency exchange rate fluctuations could adversely affect our results of operations.

A significant proportion of our revenue is generated from operations outside of the United States. We own and operate manufacturing facilities in Canada, Germany, France, the United Kingdom and the Philippines. A significant portion of our business is transacted in currencies other than the U.S. dollar such as euros, British pound, Canadian dollars or Philippine peso. Our euro denominated revenue exceeds euro expenses by approximately 120 million. With respect to the British pound, Canadian dollar, and Philippine peso, we have greater outflows than inflows of these currencies, although to a lesser degree. As a result, we are exposed to changes in currency exchange rates and such changes could be significant.

Economic weakness, the potential inability of certain European countries to continue to service their sovereign debt obligations, and the related actions of this region s central banks has caused, and could continue to cause, the value of the euro to weaken. As a result, our operating results could be negatively impacted. In the event that one or more European countries were to replace the euro with another currency, business may be adversely affected until stable exchange rates are established.

Our ability to maintain our products price competitiveness is reliant, in part, on the relative strength of the currency in which the product is denominated compared to the currency of the market into which it is sold and the functional currency of our competitors. Changes in the rate of exchange of foreign currencies in relation to the U.S. dollar, and other currencies, may adversely impact our results of operations and our ability to offer products in certain markets at acceptable prices. For example, approximately $75 million of our revenue in 2015 was earned from shipments to customers located in Ukraine, Russia and members of the CIS. Although these sales are denominated in euros, a significant weakening of the customers local currencies has and may continue to adversely affect our revenue, our customers credit risk and our results of operation.

The cost of raw materials and energy used to manufacture our products could increase and the availability of certain raw materials could become constrained.

We require access to sufficient and reasonably priced quantities of pulpwood, purchased pulps, pulp substitutes, abaca fiber, synthetic fibers, and certain other raw materials.

Our Specialty Papers locations are vertically integrated manufacturing facilities that can generate approximately 85% of their annual pulp requirements.

Our Philippine mill purchases abaca fiber to produce abaca pulp, a key material used to manufacture paper for single-serve coffee, tea and technical specialty products at our Gernsbach, Scaër, and Lydney facilities. At certain times, the supply of abaca fiber has been constrained due to factors such as weather-related damage to the source crop as well as decisions by land owners to produce alternative crops in lieu of those used to produce abaca fiber.

Our Advanced Airlaid Materials business unit requires access to sufficient quantities of fluff pulp, the supply of which is subject to availability of certain softwoods. Softwood availability can be limited by many factors, including weather in regions where softwoods are abundant.

The cost of many of our production materials, including petroleum based chemicals and freight charges, are influenced by the cost of oil. In addition, although we are currently converting our boilers to burn natural gas, coal is currently a principal source of fuel for both the Spring Grove and Chillicothe facilities. Natural gas is used as a source of fuel at Chillicothe and our Composite Fibers and Advanced Airlaid Materials business units facilities.

Government rules, regulations and policies have an impact on the cost of certain energy sources, particularly for our European operations. We currently benefit from a number of government sponsored programs related to, among others, green energy or renewable energy initiatives designed to mitigate the cost of electricity to larger industrial consumers of power. Any reduction in the extent of government sponsored incentives may adversely affect the cost ultimately borne by our operations.

Although we have contractual cost pass-through arrangements with certain Advanced Airlaid Materials customers, we may not be able to fully pass increased raw materials or energy costs on to all customers if the market will not bear the higher price or if existing agreements limit price increases. If price adjustments significantly trail increases in raw materials or energy prices, our operating results could be adversely affected.

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Our industry is highly competitive and increased competition could reduce our sales and profitability.

Specialty Papers The primary market for our Specialty Papers business unit is the United States, which has been adversely affected by capacity exceeding the demand for products, increased imports from foreign competitors and by declining uncoated free sheet demand. As a result, the industry has taken steps to reduce capacity. However, slowing demand or increased competition could force us to lower our prices or to offer additional services at a higher cost to us, which could reduce our gross margins and net income. The greater financial resources of certain of our competitors may enable them to commit larger amounts of capital in response to changing market conditions. Certain competitors may also have the ability to develop product or service innovations that could put us at a competitive disadvantage.

There have been periods of supply/demand imbalance in our industry which have caused pulp prices and our products selling prices to be volatile. The timing and magnitude of price increases or decreases in these markets have generally varied by region and by product type. A sustained period of weak demand or excess supply would likely adversely affect pulp prices and our products selling prices. This could have a material adverse effect on our operating and financial results.

Some of the other factors that may adversely affect our ability to compete in Specialty Papers markets in which we participate include:

- the entry of new competitors into the markets we serve;
- the prevalence of imported product, particularly uncoated free sheet, into the U.S.;
- the willingness of commodity-based producers to enter our markets when they are unable to compete or when demand softens in their traditional markets;
- the aggressiveness of our competitors pricing strategies, which could force us to decrease prices in order to maintain market share;
- our failure to anticipate and respond to changing customer preferences;
- the impact of electronic-based substitutes for certain of our products such as carbonless and forms, book publishing, and envelope papers;
- the impact of replacement or disruptive technologies;
- changes in end-user preferences;
- our inability to develop new, improved or enhanced products;
- our inability to maintain the cost efficiency of our facilities; and
- the cost of regulatory environmental compliance requirements.

Composite Fibers and Advanced Airlaid Materials The global markets in which we compete, although growing, are not as large as the markets for Specialty Papers. As a result, our ability to compete is more sensitive to and may be adversely impacted by the following:

- the entry of new competitors into the markets we serve;
- the aggressiveness of our competitors pricing strategies, which could force us to decrease prices in order to maintain market share;
- our failure to anticipate and respond to changing customer preferences; and
- technological advances or changes that impact production of our products.

The impact of any significant changes may result in our inability to effectively compete in the markets in which we operate, and as a result our sales and operating results would be adversely affected.

We may not be able to develop new products acceptable to our existing or potential customers.

Our business strategy is market focused and includes investments in developing new products to meet the changing needs of our customers or serve new customers and to maintain our market share. Our success will depend, in part, on our ability to develop and introduce new and enhanced products that keep pace with introductions by our competitors and changing customer preferences. If we fail to anticipate or respond adequately to these factors, we may lose opportunities for business with both current and potential customers. The success of our new product offerings will depend on several factors, including our ability to:

- anticipate and properly identify our customers needs and industry trends;

- develop and commercialize new products and applications in a timely manner;
- price our products competitively;
- differentiate our products from our competitors products; and
- invest efficiently in research and development activities.

Our inability to develop new products or new business opportunities could adversely impact our business and ultimately harm our profitability.

We are subject to substantial costs and potential liability for environmental matters.

We are subject to various environmental laws and regulations that govern our operations, including discharges into the environment, and the handling and disposal of hazardous substances and wastes. We are also subject to laws and regulations that impose liability and clean-up responsibility for releases of hazardous substances into the environment. To comply with environmental laws and regulations, we have incurred, and will continue to incur, substantial capital and operating expenditures. The Clean Air Act, and similar regulations, will impose significant compliance costs or require significant capital expenditures. Compliance with the Clean Air Act will require process modifications and/or installation of air pollution controls on boilers at two of our facilities, as well as connecting to gas pipelines. Because of the complexities of this initiative, our inability to successfully complete all aspects of the project could adversely impact the expenditures required or our results of operations.

We anticipate that environmental regulation of our operations will continue to become more burdensome and that capital and operating expenditures necessary to comply with environmental regulations will continue, and perhaps increase, in the future. Because environmental regulations are not consistent worldwide, our ability to compete globally may be adversely affected by capital and operating expenditures required for environmental compliance. In addition, we may incur obligations to remove or mitigate any adverse effects on the environment, such as air and water quality, resulting from mills we operate or have operated. Potential obligations include compensation for the restoration of natural resources, personal injury and property damages. See Item 1 Environmental Matters for an additional discussion of expected costs to comply with environmental regulations.

We have exposure to potential liability for remediation and other costs related to the presence of polychlorinated biphenyls (PCBs) in the lower Fox River on which our former Neenah, Wisconsin mill was located. During 2015, we incurred $9.7 million for remediation activities in the downstream portion of the river and it is possible we may incur a similar amount in 2016. While we believe this to be a reasonable estimation of our current exposure, there can be no assurance that we will not be required to provide significant contributions to fund remediation efforts in the near term and/or ultimately pay material amounts to resolve our liability in the Fox River matter. We have financial reserves for environmental matters, including the Fox River site, but we cannot be certain that those reserves will be adequate to provide for future obligations related to these matters, that our share of costs and/or damages for these matters will not exceed our available resources, or that such obligations will not have a long-term, material adverse effect on our consolidated financial position, liquidity or results of operations.

Our environmental issues are complex and should be reviewed in the context set forth in more detail in Item 8 Financial Statements and Supplementary Data Note 23.

The Advanced Airlaid Materials business unit generates a substantial portion of its revenue from one customer serving the hygiene products market, the loss of which could have a material adverse effect on our results of operations.

The majority of Advanced Airlaid Materials net sales of hygiene products are from one customer. In addition, sales to the feminine hygiene market accounted for 74% of Advanced Airlaid Materials net sales in 2015 and sales are concentrated within a small group of large customers. The loss of the large customer or a decline in sales of hygiene products could have a material adverse effect on this business s operating results. Our ability to effectively compete could be affected by technological production alternatives which could provide substitute products into this market segment. Customers in the airlaid nonwoven fabric material market, including the hygiene market, may also switch to less expensive products, change preferences or otherwise reduce demand for Advanced Airlaid Material s products, thus reducing the size of the markets in which it currently sells its products. Any of the foregoing could have a material adverse effect on our financial performance and business prospects.

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Our operations may be impaired and we may be exposed to potential losses and liability as a result of natural disasters, acts of terrorism or sabotage or similar events.

If we have a catastrophic loss or unforeseen operational problem at any of our facilities, we could suffer significant lost production which could impair our ability to satisfy customer demands.

Natural disasters, such as earthquakes, hurricanes, typhoons, flooding or fire, and acts of terrorism or sabotage affecting our operating activities and major facilities could materially and adversely affect our operations, operating results and financial condition.

In addition, we own and maintain two dams in York County, Pennsylvania, that were built to ensure a steady supply of water for the operation of our facility in Spring Grove which is a primary manufacturing location for our envelope papers and engineered products. Each of these dams is classified as high hazard by the Commonwealth of Pennsylvania because they are located in close proximity to inhabited areas. Any sudden failure of a dam, including as a result of natural disaster or act of terrorism or sabotage, would endanger occupants and residential, commercial and industrial structures, for which we could be liable. The failure of a dam could also be extremely disruptive and result in damage to, or the shutdown of, our Spring Grove mill. Any losses or liabilities incurred due to the failure of one of our dams may not be fully covered by or may substantially exceed the limits of our insurance policies and could materially and adversely affect our operating results and financial condition.

In addition, many of our papermaking operations require a reliable and abundant supply of water. Such mills rely on a local water body or water source for their water needs and, therefore, are particularly impacted by drought conditions or other natural or manmade interruptions to water supplies. At various times and for differing periods, each of our mills has had to modify operations due to water shortages, water clarity, or low flow conditions in its principal water supplies. Any interruption or curtailment of operations at any of our paper mills due to drought or low flow conditions at the principal water source or another cause could materially and adversely affect our operating results and financial condition.

Our pulp mill in Lanao del Norte on the Island of Mindanao in the Republic of the Philippines is located along the Pacific Rim, one of the world s hazard belts. By virtue of its geographic location, this mill is subject to similar types of natural disasters discussed above, cyclones,

typhoons, and volcanic activity. Moreover, the area of Lanao del Norte has been a target of suspected terrorist activities. Our pulp mill in Mindanao is located in a rural portion of the island and is susceptible to attacks or power interruptions. The Mindanao mill supplies the abaca pulp used by our Composite Fibers business unit to manufacture our paper for single serve coffee and tea products and certain technical specialties products. Any interruption, loss or extended curtailment of operations at our Mindanao mill could affect our ability to meet customer demands for our products and materially affect our operating results and financial condition.

We have operations in a potentially politically and economically unstable location.

Our pulp mill in the Philippines is located in a region that is unstable and subject to political unrest. As discussed above, our Philippine pulp mill produces abaca pulp, a significant raw material used by our Composite Fibers business unit, and is currently our main provider of abaca pulp. There are limited suitable alternative sources of readily available abaca pulp in the world. In the event of a disruption in supply from our Philippine mill, there is no guarantee that we could obtain adequate amounts of abaca pulp, if at all, from alternative sources at a reasonable price. Further, there is no assurance the performance of such alternative materials will be satisfy customer performance requirements. As a consequence, any civil disturbance, unrest, political instability or other event that causes a disruption in supply could limit the availability of abaca pulp and would increase our cost of obtaining abaca pulp. Such occurrences could adversely impact our sales volumes, revenues and operating results.

Our international operations pose certain risks that may adversely impact sales and earnings.

We have significant operations and assets located in Canada, Germany, France, the United Kingdom, and the Philippines. Our international sales and operations are subject to a number of unique risks, in addition to the risks in our domestic sales and operations, including differing protections of intellectual property, trade barriers, labor unrest, exchange controls, regional economic uncertainty, differing (and possibly more stringent) labor regulation, risk of governmental expropriation, domestic and foreign customs and tariffs, differing regulatory environments, difficulty in managing widespread operations and political instability. These factors may adversely affect our future profits. Also, in some foreign jurisdictions, we may be subject to laws limiting the right and ability of entities organized or operating therein to pay dividends or remit earnings to affiliated companies unless specified conditions are met. Any such limitations would restrict our flexibility in using funds generated in those jurisdictions.

We are subject to cyber-security risks related to unauthorized or malicious access to sensitive customer, vendor, company or employee information as well as to the technology that supports our operations and other business processes.

Our business operations rely upon secure systems for mill operations, and data capture, processing, storage and reporting. Although we maintain appropriate data security and controls, our information technology systems, and those of our third party providers, could become subject to cyber attacks. Systems such as ours are inherently exposed to cyber-security risks and potential attacks. The result of such attacks could result in a breach of data security and controls. Such a breach of our network, systems, applications or data could result in operational disruptions or damage or information misappropriation including, but not limited to, interruption to systems availability, denial of access to and misuse of applications required by our customers to conduct business with us, denial of access to the applications we use to plan our operations, procure materials, manufacture and ship products and account for orders, theft of intellectual knowhow and trade secrets, and inappropriate disclosure of confidential company, employee, customer or vendor information, could stem from such incidents.

Any of these operational disruptions and/or misappropriation of information could adversely affect our results of operations, create negative publicity and could have a material effect on our business.

We operate in and are subject to taxation from numerous U.S. and foreign jurisdictions.

The multinational nature of our business subjects us to taxation in the U.S and numerous foreign jurisdictions. Due to economic and political conditions, tax rates in various jurisdictions may be subject to significant change. Our effective tax rates could be affected by changes in tax laws or their interpretation or changes in the mix of earnings in jurisdictions with differing statutory tax rates, changes in the valuation of deferred tax assets and liabilities. For example, the European Commission has

opened formal investigations to examine whether decisions by the tax authorities in certain European countries comply with European Union rules on state aid. The outcome of the European Commission s investigations could require changes to existing tax rulings that, in turn, could have an impact on our income taxes and results of operations.

In the event any of the above risk factors impact our business in a material way or in combination during the same period, we may be unable to generate sufficient cash flow to simultaneously fund our operations, finance capital expenditures, satisfy obligations and make dividend payments on our common stock.

In addition to debt service obligations, our business is capital intensive and requires significant expenditures to support growth strategies, research and development initiatives, environmental compliance, and for normal upgrades or replacements. During 2016, we expect our use of cash for capital expenditures, strategic investments and environmental compliance projects will exceed cash generated from operations. We expect to meet all of our near and long-term cash needs from a combination of operating cash flow, cash and cash equivalents, our existing credit facility and other long-term debt. If we are unable to generate sufficient cash flow from these sources, we could be unable to meet our near and long-term cash needs or make dividend payments.

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

ITEM 2 PROPERTIES

We own substantially all of the land and buildings comprising our manufacturing facilities located in Pennsylvania; Ohio; Canada; the United Kingdom; Germany; France; and the Philippines; as well as substantially all of the equipment used in our manufacturing and related operations. Certain of our operations are under lease arrangements including our metallized paper production facility located in Caerphilly, Wales, office and warehouse space in Moscow, Russia, Souzou, China and our corporate offices in York, Pennsylvania. All of our properties, other than those that are leased, are free from any material liens or encumbrances. We consider all of our buildings to be in good structural condition and well maintained and our properties to be suitable and adequate for present operations.

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ITEM 3 LEGAL PROCEEDINGS

We are involved in various lawsuits that we consider to be ordinary and incidental to our business. The ultimate outcome of these lawsuits cannot be predicted with certainty; however, except with respect to the Fox River matter referred to below, we do not expect such lawsuits, individually or in the aggregate, will have a material adverse effect on our consolidated financial position, liquidity or results of operations.

We are one of several defendants in a significant environmental matter relating to contamination in the Fox River and Bay of Green Bay in Wisconsin. For a discussion this matter, see Item 8 Financial Statements and Supplementary Data Note 23.

EXECUTIVE OFFICERS

The following table sets forth certain information with respect to our executive officers and senior management as of February 26, 2016.

Name	Age	Office with the Company
Dante C. Parrini	51	Chairman and Chief Executive Officer
John P. Jacunski	50	Executive Vice President and Chief Financial Officer
Christopher W. Astley	43	Senior Vice President & Business Unit President, Advanced Airlaid Materials
Brian E. Janki	43	Senior Vice President & Business Unit President, Specialty Papers
Martin Rapp	56	Senior Vice President & Business Unit President, Composite Fibers
William T. Yanavitch II	55	Senior Vice President, Human Resources and Administration
David C. Elder	47	Vice President, Finance
Kent K. Matsumoto	56	Vice President, General Counsel and Corporate Secretary
Mark A. Sullivan	60	Vice President

Officers are elected to serve at the pleasure of the Board of Directors. Except in the case of officers elected to fill a new position or a vacancy occurring at some other date, officers are generally elected at the organizational meeting of the Board of Directors held immediately after the annual meeting of shareholders.

Dante C. Parrini became Chief Executive Officer effective January 1, 2011 and Chairman of the Board in May 2011. Prior to this, he was Executive Vice President and Chief Operating Officer, a position he held since February 2005. Mr. Parrini joined us in 1997 and has previously served as Senior Vice President and General Manager, a position he held beginning in January 2003

and prior to that as Vice President responsible for Sales and Marketing.

John P. Jacunski was promoted to Executive Vice President and Chief Financial Officer in February 2014. He joined us in October 2003 and served as Vice President and Corporate Controller. In July 2006 he was promoted to Senior Vice President and Chief Financial Officer. Mr. Jacunski was previously Vice President and Chief Financial Officer at WCI Steel, Inc. from June 1999 to October 2003. Prior to joining WCI, Mr. Jacunski was with KPMG, an international accounting and consulting firm, where he served in various capacities.

Christopher W. Astley was named Senior Vice President & Business Unit President, Advanced Airlaid Materials in January 2015. He joined us in August 2010 as Vice President, Corporate Strategy and was promoted to Senior Vice President in February 2014. Prior to joining us, he was an entrepreneur leading a privately held business from 2004 until 2010. Prior to that Mr. Astley held positions with Accenture, a global management consulting firm, and The Coca-Cola Company.

Brian E. Janki serves as Senior Vice President & Business Unit President, Specialty Papers. Prior to joining us in August 2013 Mr. Janki was employed by Greif as their Vice President & General Manager, Rigid Industrial Packaging & Services. During his twelve years with Greif, Mr. Janki held leadership positions including profit/loss responsibilities for two business units, global responsibility for supply chain and sourcing, and transformational assignments including global oversight of the implementation of the Greif Business System.

Martin Rapp serves as Senior Vice President & Business Unit President, Composite Fibers. Mr. Rapp joined us in August 2006 and has lead the Composite Fibers business unit since that time. Prior to this, he was Vice President and General Manager of Avery Dennison s Roll Materials Business in Central and Eastern Europe since August 2002.

William T. Yanavitch II was promoted to Senior Vice President Human Resources and Administration in February 2014. Since joining us in July 2000, he has served as Vice President, Human Resources. Prior to joining us he worked for Dentsply International and Gould Pumps Inc. in various leadership capacities.

David C. Elder was named Vice President, Finance in December 2011 and continues as our chief accounting officer. Prior to his promotion, he was our Vice President, Corporate Controller, a position held since joining

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Glatfelter in January 2006. Mr. Elder was previously Corporate Controller for YORK International Corporation.

Kent K. Matsumoto was appointed Vice President, General Counsel and Corporate Secretary in October 2013. Mr. Matsumoto joined us in June 2012 as Assistant General Counsel and also served as interim General Counsel from March 2013 to October 2013. From July 2008 until February 2012, he was Associate General Counsel for Wolters Kluwer.

Mark A. Sullivan serves as a Vice President. Previously, he was Vice President, Global Supply Chain and Information Technology since his promotion in November 2012. Mr. Sullivan joined us in December 2003 as Chief Procurement Officer and he was appointed Vice President, Global Supply Chain in February 2005.

ITEM 4 MINE SAFETY DISCLOSURES

Not Applicable

PART II

ITEM 5 MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

STOCK PERFORMANCE GRAPH

The following graph compares the cumulative 5-year total return of our common stock with the cumulative total returns of both a peer group and a broad market index. We compare our stock performance to the S&P Small Cap 600 Paper Products index comprised of us, Clearwater Paper Corp., Kapstone Paper & Packaging Corp., Neenah Paper Inc., Schweitzer-Mauduit International and Wausau Paper Corp. In addition, the chart includes a comparison to the Russell 2000, which we believe is an appropriate benchmark index for stocks such as ours. The following graph assumes that the value of the investment in our common stock, in each index, and in the peer group

(including reinvestment of dividends) was $100 on December 31, 2010 and charts it through December 31, 2015.

Common Stock Prices and Dividends Declared Information

The following table shows the high and low prices of our common stock traded on the New York Stock Exchange under the symbol GLT and the dividend declared per share for each quarter during the past two years:

Quarter	High	Low	Dividend
2015			
Fourth	**$ 20.09**	**$ 16.28**	**$ 0.12**
Third	**22.47**	**16.56**	**0.12**
Second	**27.40**	**21.81**	**0.12**
First	**27.58**	**22.18**	**0.12**
2014			
Fourth	$ 27.18	$ 21.38	$ 0.11
Third	27.19	21.94	0.11
Second	27.54	24.07	0.11
First	32.00	26.52	0.11

As of February 24, 2016, we had 1,064 shareholders of record.

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ITEM 6 SELECTED FINANCIAL DATA

As of or for the year ended December 31

Dollars in thousands, except per share	**2015**	2014	2013 (1)	2012	2011
Net sales	**$ 1,661,084**	$ 1,802,415	$ 1,722,615	$ 1,577,788	$ 1,603,154
Energy and related sales, net	**5,664**	7,927	3,153	7,000	9,344
Total revenue	**1,666,748**	1,810,342	1,725,768	1,584,788	1,612,498
Gains on dispositions of plant, equipment and timberlands, net	**21,113**	4,861	1,726	9,815	3,950
Net income	**$ 64,575**	$ 69,246	$ 67,158	$ 59,379	$ 42,694
Earnings per share					
Basic	**$ 1.49**	$ 1.60	$ 1.56	$ 1.39	$ 0.94
Diluted	**1.47**	1.57	1.52	1.36	0.93
Total assets	**$ 1,503,624**	$ 1,561,504	$ 1,678,410	$ 1,242,985	$ 1,136,925
Total debt	**363,870**	404,612	442,325	250,000	227,000
Shareholders equity	**663,247**	649,109	684,476	539,679	490,404
Cash dividends declared per common share	**0.48**	0.44	0.40	0.36	0.36
Depreciation, depletion and amortization	**63,236**	70,555	68,196	69,500	69,313
Capital expenditures	**99,889**	66,046	103,047	58,752	64,491
Net tons sold	**1,051,911**	1,059,881	1,029,819	969,833	960,915
Number of employees	**4,375**	4,516	4,403	4,258	4,274

(1) On April 30, 2013, we acquired Dresden Papier GmbH, the results of which are included prospectively from the acquisition date, including $101.8 million of net sales and $18.3 million of operating income.

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

Forward-Looking Statements This Annual Report on Form 10-K includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact, including statements regarding industry prospects and future consolidated financial position or results of operations, made in this Report on Form 10-K are forward looking. We use words such as anticipates , believes , expects , future , intends and similar expressions to identify forward-looking statements. Forward-looking statements reflect management s current expectations and are inherently uncertain. Our actual results may differ significantly from such expectations. The following discussion includes forward-looking statements regarding expectations of, among others, non-cash pension expense, environmental costs, capital expenditures and liquidity, all of which are inherently difficult to predict. Although we make such statements based on assumptions that we believe to be reasonable, there can be no assurance that actual results will not differ materially from our expectations. Accordingly, we identify the following important factors, among others, which could cause our results to differ from any results that might be projected, forecasted or estimated in any such forward-looking statements:

i. variations in demand for our products including the impact of unplanned market-related downtime, variations in product pricing, or product substitution;

ii. the impact of competition, both domestic and international, changes in industry production capacity, including the construction of new mills or new machines, the closing of mills and incremental changes due to capital expenditures or productivity increases;

iii. risks associated with our international operations, including local economic and political environments and fluctuations in currency exchange rates;

iv. geopolitical events, including the impact of conflicts such as Russia and Ukraine;

v. our ability to develop new, high value-added products;

vi. changes in the cost or availability of raw materials we use, in particular pulpwood, pulp, pulp substitutes, caustic soda, and abaca fiber;

vii. changes in energy-related costs and commodity raw materials with an energy component;

viii. the impact of unplanned production interruption;

ix. disruptions in production and/or increased costs due to labor disputes;

x. the impact of exposure to volatile market-based pricing for sales of excess electricity;

xi. the gain or loss of significant customers and/or on-going viability of such customers;

xii. cost and other effects of environmental compliance, cleanup, damages, remediation or restoration, or personal injury or property damages related thereto, such as the costs of natural resource restoration or damages related to the presence of polychlorinated biphenyls (PCBs) in the lower Fox River on which our former Neenah mill was located;

xiii. adverse results in litigation in the Fox River matter;

xiv. the impact of war and terrorism;

xv. the impact of unfavorable outcomes of audits by various state, federal or international tax authorities;

xvi. enactment of adverse state, federal or foreign tax or other legislation or changes in government policy or regulation; and

xvii. our ability to finance, consummate and integrate acquisitions.

Introduction We manufacture a wide array of specialty papers and fiber-based engineered materials and we manage our company along three business units:

Composite Fibers with revenue from the sale of single-serve tea and coffee filtration papers, nonwoven wall covering materials, metallized papers, composite laminates papers, and many technically special papers including substrates for electrical applications;

Advanced Airlaid Materials with revenue from the sale of airlaid nonwoven fabric-like materials used in feminine hygiene and adult incontinence products, wipes, and other airlaid applications; and

Specialty Papers with revenue from the sale of papers for carbonless and other forms, envelopes, book publishing, and engineered products such as papers for high-speed ink jet printing, office specialty products, greeting cards, packaging, casting, release, transfer, playing card, postal, FDA-compliant food and beverage applications, and other niche specialty applications.

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RESULTS OF OPERATIONS

2015 versus 2014

Overview Net income for 2015 was $64.6 million, or $1.47 per diluted share, compared with $69.2 million, or $1.57 per diluted share, in 2014. On an adjusted earnings basis, a non-GAAP measure that excludes non-core business items discussed below, earnings per share were $1.34 compared with $1.55 in 2014. The year-over-year comparison of results of operations reflects the adverse impact of i) the stronger U.S. dollar on our euro-denominated businesses; ii) weaker demand and pricing for nonwoven wallcover products primarily due to economic conditions in Russia and Ukraine; iii) pricing pressures in our Specialty Papers business; and iv) weaker demand for certain Advanced Airlaid Materials products in the first half of 2015.

During 2015, we implemented cost reduction and continuous improvement initiatives that generated $31 million of savings. Our workforce was reduced by 3.1%.

We generated $133.7 million of cash flow from operations compared with $99.6 million in 2014. We also returned additional cash to our shareholders in the form of a 9% increase in the quarterly dividend beginning with the 2015 first quarter dividend payment. This was the third consecutive year in which the dividend was increased.

We also announced a plan to invest $80 million to build a new production facility in the United States in the Advanced Airlaid Materials business (AMBU). Our plan to build this new facility is in direct response to customer needs for increased capacity in a tightening North American airlaid market.

On October 1, 2014, we completed the acquisition of Spezialpapierfabrik Oberschmitten GmbH (SPO) for $8.0 million in cash. SPO s results are reported as part of the Composite Fibers business unit prospectively from the acquisition date. It primarily produces highly technical papers for use in a wide range of capacitors used in consumer and industrial products; insulation papers for cables and transformers; and materials for industrial power inverters, electromagnetic current filters and electric rail traction.

The following table sets forth summarized results of operations:

	Year ended December 31	
In thousands, except per share	**2015**	2014
Net sales	**$ 1,661,084**	$ 1,802,415
Gross profit	**202,965**	235,154
Operating income	**96,372**	106,780
Net income	**64,575**	69,246
Earnings per diluted share	**1.47**	1.57

Consolidated net sales for year ended December 31, 2015 were $1,661.1 million compared with $1,802.4 million for 2014. On a constant currency basis, net sales declined $40.3 million, or 2.2 percent. Shipping volumes declined less than one percent.

In addition to the results reported in accordance with GAAP, we evaluate our performance using adjusted net income and adjusted earnings per diluted share. We disclose this information so that investors can evaluate our performance exclusive of certain unique or unusual items that impact the comparability of results from period to period as it allows them to understand underlying operating trends and cash flow generation.

Adjusted earnings per diluted share is calculated by dividing adjusted net income by diluted weighted-average shares outstanding. Adjusted earnings and adjusted earnings per diluted share are considered measures not calculated in accordance with GAAP, and therefore are non-GAAP measures. These non-GAAP measures may differ from other companies. The non-GAAP financial information should not be considered in isolation from, or as a substitute for, measures of financial performance prepared in accordance with GAAP. The following table sets for the reconciliation of net income to adjusted earnings for the years ended December 31, 2015 and 2014:

In thousands, except per share	After-tax amounts	Diluted EPS
2015		

Net income	**$ 64,575**	**$ 1.47**
Timberland sales and related costs	**(14,652)**	**(0.33)**
Fox River environmental matter	**6,222**	**0.14**
Workforce efficiency charges	**1,768**	**0.04**
Asset impairment charge	**857**	**0.02**
Acquisition and integration related costs	**126**	
AMBU capacity expansion costs	**30**	
Adjusted earnings (non-GAAP)	**$ 58,926**	**$ 1.34**

2014		
Net income	$ 69,246	$ 1.57
Timberland sales and related costs	(2,995)	(0.07)
Workforce efficiency charges	373	0.01
Asset impairment charge	2,356	0.05
Acquisition and integration related costs	603	0.01
Alternative fuel mixture/Cellulosic biofuel credits	(1,115)	(0.03)
Adjusted earnings (non-GAAP)	$ 68,468	$ 1.55

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The sum of individual per share amounts set forth above may not agree to adjusted earnings per share due to rounding.

Adjusted net income consists of net income determined in accordance with GAAP adjusted to exclude the impact of the following:

Timberland sales and related costs. These adjustments exclude gains from the sales of timberlands as these items are not considered to be part of our core business, ongoing results of operations or cash flows. These adjustments are irregular in timing and amount and may significantly impact our operating performance. As such, these items may not be indicative of past or future performance of the Company and therefore are excluded for comparability purposes.

Fox River environmental matter. This adjustment reflects a charge incurred to increase our reserve for estimated costs to remediate environmental contamination at the Fox River site. These costs are irregular in timing and as such may not be indicative of our past or future performance.

Workforce efficiency charges. These adjustments include costs that are directly related to

actions undertaken to reduce costs and improve operating efficiencies. Such costs were specifically incurred as part of our initiative to reduce global headcount as part of a more broad based cost reduction program announced at the end of 2014.

Asset impairment charges. This adjustment represents a non-cash charge required to adjust to its estimated fair value the carrying value of a trade name intangible asset. Charges of this nature are irregular in timing and as such may not be indicative of our past and future performance.

Acquisition and integration related costs. These adjustments include costs directly related to the consummation of the acquisition process and those related to integrating recently acquired businesses. These costs are irregular in timing and as such may not be indicative of our past or future performance.

Alternative fuel mixture/Cellulosic biofuel credits. These adjustments reflect the release of reserves for uncertain tax position due to the lapse of statutes of limitation.

AMBU capacity expansion costs. These adjustments reflect costs incurred directly related to the start-up of a new production facility for AMBU.

Business Unit Performance

	Year ended December 31									
Dollars in millions	Composite Fibers		Advanced Airlaid Materials		Specialty Papers		Other and Unallocated		Total	
	2015	2014	**2015**	2014	**2015**	2014	**2015**	2014	**2015**	2014
Net sales	**$ 541.5**	$ 617.9	**$ 244.6**	$ 281.7	**$ 875.0**	$ 902.9	**$**	$	**$ 1,661.1**	$ 1,802.4
Energy and related sales, net					**5.7**	7.9			**5.7**	7.9
Total revenue	**541.5**	617.9	**244.6**	281.7	**880.7**	910.8			**1,666.7**	1,810.3
Cost of products sold	**434.4**	498.0	**215.7**	247.6	**804.5**	821.8	**9.2**	7.8	**1,463.8**	1,575.2
Gross profit (loss)	**107.1**	119.9	**28.9**	34.1	**76.2**	89.0	**(9.2)**	(7.8)	**203.0**	235.2
SG&A	**45.7**	51.6	**7.6**	8.8	**43.3**	50.4	**31.0**	22.4	**127.7**	133.2
Gains on dispositions of plant, equipment and timberlands, net							**(21.1)**	(4.9)	**(21.1)**	(4.9)
Total operating income (loss)	**61.4**	68.3	**21.3**	25.3	**32.9**	38.6	**(19.1)**	(25.3)	**96.4**	106.8
Non-operating expense										

Diluted net

income (loss) per share:						
Continuing operations	$5.24	$5.24	$5.24	$5.33	$5.33	$5.33
Discontinued operations	(0.27)	(0.27)	(0.27)	(0.29)	(0.29)	(0.29)
Diluted net income per share	$4.97	$4.97	$4.97	$5.04	$5.04	$5.04

The number of shares and per share amounts for the prior period presented have been retroactively restated to reflect the two-for-one stock split effected in the form of a stock dividend issued on April 2, 2014.
The net income per share amounts are the same for Class A and Class B common stock and Class C capital stock because the holders of each class are legally entitled to equal per share distributions whether through dividends or in liquidation.

Note 3. Financial Instruments

Fair Value Measurements

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We measure our cash equivalents, marketable securities, and foreign currency and interest rate derivative contracts at fair value on a recurring basis. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. Assets and liabilities recorded at fair value are measured and classified in accordance with a three-tier fair value hierarchy based on the observability of the inputs available in the market used to measure fair value:

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

Level 2 - Inputs that are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant inputs are observable in the market or can be derived from observable market data. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign exchange rates, and credit ratings.

Level 3 - Unobservable inputs that are supported by little or no market activities.

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

We classify our cash equivalents and marketable securities within Level 1 or Level 2 because we use quoted market prices or alternative pricing sources and models utilizing market observable inputs to determine their fair value. We classify our foreign currency and interest rate derivative contracts primarily within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments.

Cash, Cash Equivalents and Marketable Securities

The following tables summarize our cash, cash equivalents and marketable securities by significant investment categories as of December 31, 2013 and March 31, 2014 (in millions):

	As of December 31, 2013					
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Marketable Securities
Cash	$9,909	$0	$0	$9,909	$9,909	$0
Level 1:						
Money market and other funds	4,428	0	0	4,428	4,428	0
U.S. government notes	18,276	23	(37)	18,262	2,501	15,761
Marketable equity securities	197	167	0	364	0	364
	22,901	190	(37)	23,054	6,929	16,125
Level 2:						
Time deposits[1]	1,207	0	0	1,207	790	417
Money market and other funds[2]	1,270	0	0	1,270	1,270	0
U.S. government agencies	4,575	3	(3)	4,575	0	4,575
Foreign government bonds	1,502	5	(26)	1,481	0	1,481
Municipal securities	2,904	9	(36)	2,877	0	2,877
Corporate debt securities	7,300	162	(67)	7,395	0	7,395
Agency residential mortgage-backed securities	5,969	27	(187)	5,809	0	5,809
Asset-backed securities	1,142	0	(2)	1,140	0	1,140
	25,869	206	(321)	25,754	2,060	23,694
Total	$58,679	$396	$(358)	$58,717	$18,898	$39,819

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	As of March 31, 2014					
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Marketable Securities
	(unaudited)					
Cash	$9,212	$0	$0	$9,212	$9,212	$0
Level 1:						
Money market and other funds	3,212	0	0	3,212	3,212	0
U.S. government notes	18,034	24	(22)	18,036	852	17,184
Marketable equity securities	190	190	0	380	0	380
	21,436	214	(22)	21,628	4,064	17,564
Level 2:						
Time deposits[1]	1,762	0	0	1,762	1,260	502
Money market and other funds[2]	2,103	0	0	2,103	2,103	0
U.S. government agencies	5,674	3	(2)	5,675	0	5,675
Foreign government bonds	1,719	9	(15)	1,713	0	1,713
Municipal securities	2,795	15	(18)	2,792	0	2,792
Corporate debt securities	7,030	185	(30)	7,185	0	7,185
Agency residential mortgage-backed securities	6,151	36	(144)	6,043	0	6,043
Asset-backed securities	1,267	0	(1)	1,266	0	1,266
	28,501	248	(210)	28,539	3,363	25,176
Total	$59,149	$462	$(232)	$59,379	$16,639	$42,740

(1) The majority of our time deposits are foreign deposits.

(2) The balances at December 31, 2013 and March 31, 2014 were related to cash collateral received in connection with our securities lending program, which was invested in reverse repurchase agreements maturing within three months. See below for further discussion of this program.

Cash, cash equivalents and marketable securities to be disposed of as a result of the Motorola Mobile disposition were included in "Assets held for sale" on the Consolidated Balance Sheet as of March 31, 2014, and accordingly, are not included in this table.

During the second quarter of 2013, we received approximately $175 million in Arris Group, Inc. (Arris) common stock (10.6 million shares) in connection with the sale of the Motorola Home business (see details in Note 8). These shares are accounted for as available-for-sale marketable equity securities.

We determine realized gains or losses on the sale of marketable securities on a specific identification method. We recognized gross realized gains of $75 million and $98 million for the three months ended March 31, 2013 and 2014. We recognized gross realized losses of $15 million and $24 million for the three months ended March 31, 2013 and 2014. We reflect these gains and losses as a component of interest and other income, net, in the accompanying Consolidated Statements of Income.

The following table summarizes the estimated fair value of our investments in marketable debt securities, accounted for as available-for-sale securities and classified by the contractual maturity date of the securities (in millions):

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	As of March 31, 2014 (unaudited)
Due in 1 year	$14,828
Due in 1 year through 5 years	15,431
Due in 5 years through 10 years	5,942
Due after 10 years	6,159
Total	$42,360

The following tables present gross unrealized losses and fair values for those investments that were in an unrealized loss position as of December 31, 2013 and March 31, 2014, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in millions):

	As of December 31, 2013					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government notes	$4,404	$(37)	$0	$0	$4,404	$(37)
U.S. government agencies	496	(3)	0	0	496	(3)
Foreign government bonds	899	(23)	83	(3)	982	(26)
Municipal securities	1,210	(32)	99	(4)	1,309	(36)
Corporate debt securities	2,583	(62)	69	(5)	2,652	(67)
Agency residential mortgage-backed securities	4,065	(167)	468	(20)	4,533	(187)
Asset-backed securities	643	(2)	0	0	643	(2)
Total	$14,300	$(326)	$719	$(32)	$15,019	$(358)

	As of March 31, 2014					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
			(unaudited)			
U.S. government notes	$2,583	$(22)	$0	$0	$2,583	$(22)
U.S. government agencies	472	(2)	0	0	472	(2)
Foreign government bonds	844	(10)	100	(5)	944	(15)
Municipal securities	915	(13)	106	(5)	1,021	(18)
Corporate debt securities	1,466	(25)	86	(5)	1,552	(30)
Agency residential mortgage-backed securities	3,540	(110)	570	(34)	4,110	(144)
Asset-backed securities	0	0	90	(1)	90	(1)
Total	$9,820	$(182)	$952	$(50)	$10,772	$(232)

We periodically review our marketable debt and equity securities for other-than-temporary impairment. We consider factors such as the duration, severity and the reason for the decline in value, the potential recovery period and our intent to sell. For marketable debt securities, we also consider whether (i) it is more likely than not that we will be required to sell the debt securities before recovery of their amortized cost basis, and (ii) the amortized cost basis cannot be recovered as a result of credit losses. During the three months ended March 31, 2013 and 2014, we did not recognize any other-than-temporary impairment loss.

Securities Lending Program

From time to time, we enter into securities lending agreements with financial institutions to enhance investment income. We loan selected securities which are collateralized in the form of cash or securities. Cash collateral is invested in reverse repurchase agreements which are collateralized in the form of securities.

We classify loaned securities as cash equivalents or marketable securities and record the cash collateral as an asset with a corresponding liability in the accompanying Consolidated Balance Sheets. We classify reverse repurchase agreements maturing within three months as cash equivalents and those longer than three months as receivable under reverse repurchase agreements in the accompanying Consolidated Balance Sheets. For security collateral received, we do not record an asset or liability except in the event of counterparty default.

Derivative Financial Instruments

We recognize derivative instruments as either assets or liabilities in the accompanying Consolidated Balance Sheets at fair value. We record changes in the fair value (i.e., gains or losses) of the derivatives in the accompanying Consolidated Statements of Income as interest and other income, net, as part of revenues, or as a component of accumulated other comprehensive income (AOCI) in the accompanying Consolidated Balance Sheets, as discussed below.

We enter into foreign currency contracts with financial institutions to reduce the risk that our cash flows and earnings will be adversely affected by foreign currency exchange rate fluctuations. We use certain interest rate derivative contracts to hedge interest rate exposures on our fixed income securities and our anticipated debt issuance. Our program is not used for trading or speculative purposes.

We enter into master netting arrangements, which reduce credit risk by permitting net settlement of transactions with the same counterparty. To further reduce credit risk, we enter into collateral security arrangements under which the counterparty is required to provide collateral when the net fair value of certain financial instruments fluctuates from contractually established thresholds. We can take possession of the collateral in the event of counterparty default. As of December 31, 2013 and March 31, 2014, we received cash collateral related to the derivative instruments under our collateral security arrangements of $35 million and $7 million.

Cash Flow Hedges

We use options designated as cash flow hedges to hedge certain forecasted revenue transactions denominated in currencies other than the U.S. dollar. The notional principal of these contracts was approximately $10.0 billion and $7.9 billion as of December 31, 2013 and March 31, 2014. These foreign exchange contracts have maturities of 36 months or less.

In 2012, we entered into forward-starting interest rate swaps, with a total notional amount of $1.0 billion and terms calling for us to receive interest at a variable rate and to pay interest at a fixed rate, that effectively locked in an interest rate on our anticipated debt issuance of $1.0 billion in 2014. We issued $1.0 billion of unsecured senior notes in February 2014 (See details in Note 4). As a result, we terminated the forward-starting interest rate swaps upon the debt issuance. The gain associated with the termination is reported within operating activities in the Consolidated Statement of Cash Flows for the three months ended March 31, 2014, consistent with the impact of the hedged item.

We reflect gains or losses on the effective portion of a cash flow hedge as a component of AOCI and subsequently reclassify cumulative gains and losses to revenues or interest expense when the hedged transactions are recorded. If the hedged transactions become probable of not occurring, the corresponding amounts in AOCI would be immediately reclassified to interest and other income, net. Further, we exclude the change in the time value of the options from our assessment of hedge effectiveness. We record the premium paid or time value of an option on the date of purchase as an asset. Thereafter, we recognize changes to this time value in interest and other income, net.

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As of March 31, 2014, the effective portion of our cash flow hedges before tax effect was $68 million, of which $17 million is expected to be reclassified from AOCI into earnings within the next 12 months.

Fair Value Hedges

We use forward contracts designated as fair value hedges to hedge foreign currency risks for our investments denominated in currencies other than the U.S. dollar. Gains and losses on these contracts are recognized in interest and other income, net, along with the offsetting losses and gains of the related hedged items. We exclude changes in the time value for forward contracts from the assessment of hedge effectiveness. The notional principal of these contracts was $1.2 billion and $1.4 billion as of December 31, 2013 and March 31, 2014.

Other Derivatives

Other derivatives not designated as hedging instruments consist of forward and option contracts that we use to hedge intercompany transactions and other monetary assets or liabilities denominated in currencies other than the local currency of a subsidiary. We recognize gains and losses on these contracts, as well as the related costs in interest and other income, net, along with the foreign currency gains and losses on monetary assets and liabilities. The notional principal of foreign exchange contracts outstanding was $9.4 billion and $7.5 billion at December 31, 2013 and March 31, 2014.

We also use exchange-traded interest rate futures contracts and “To Be Announced” (TBA) forward purchase commitments of mortgage-backed assets to hedge interest rate risks on certain fixed income securities. The TBA contracts meet the definition of derivative instruments in cases where physical delivery of the assets is not taken at the earliest available delivery date. Our interest rate futures and TBA contracts (together interest rate contracts) are not designated as hedging instruments. We recognize gains and losses on these contracts, as well as the related costs, in interest and other income, net. The gains and losses are generally economically offset by unrealized gains and losses in the underlying available-for-sale securities, which are recorded as a component of AOCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are moved from AOCI into interest and other income, net. The total notional amounts of interest rate contracts outstanding were $13 million at December 31, 2013 and $75 million at March 31, 2014.

The fair values of our outstanding derivative instruments were as follows (in millions):

		As of December 31, 2013		
	Balance Sheet Location	Fair Value of Derivatives Designated as Hedging Instruments	Fair Value of Derivatives Not Designated as Hedging Instruments	Total Fair Value
Derivative Assets:				
Level 2:				
Foreign exchange contracts	Prepaid revenue share, expenses and other assets, current and non-current	$133	$12	$145
Interest rate contracts	Prepaid revenue share, expenses and other assets, current and non-current	87	0	87
Total		$220	$12	$232
Derivative Liabilities:				
Level 2:				
Foreign exchange contracts	Accrued expenses and other current liabilities	$0	$4	$4

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	Balance Sheet Location	As of March 31, 2014 Fair Value of Derivatives Designated as Hedging Instruments (unaudited)	Fair Value of Derivatives Not Designated as Hedging Instruments	Total Fair Value
Derivative Assets:				
Level 2:				
Foreign exchange contracts	Prepaid revenue share,expenses and other assets, current and non-current and assets held for sale	$80	$4	$84
Total		$80	$4	$84
Derivative Liabilities:				
Level 2:				
Foreign exchange contracts	Accrued expenses, and other current liabilities and liabilities held for sale	$5	$13	$18
Total		$5	$13	$18

The effect of derivative instruments in cash flow hedging relationships on income and other comprehensive income (OCI) is summarized below (in millions):

Derivatives in Cash Flow Hedging Relationship	Gains (Losses) Recognized in OCI on Derivatives Before Tax Effect (Effective Portion) Three Months Ended March 31, 2013	2014
	(unaudited)	
Foreign exchange contracts	$163	$13
Interest rate contracts	10	(31)
Total	$173	$(18)

Derivatives in Cash Flow Hedging Relationship	Gains Reclassified from AOCI into Income (Effective Portion) Income Statement Location	Three Months Ended March 31, 2013	2014
		(unaudited)	
Foreign exchange contracts	Revenues	$35	$8

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Derivatives in Cash Flow Hedging Relationship	Gains (Losses) Recognized in Income on Derivatives (Amount Excluded from Effectiveness Testing and Ineffective Portion) [1] Income Statement Location	Three Months Ended March 31, 2013	2014
		(unaudited)	
Foreign exchange contracts	Interest and other income, net	$ (51)	$ (67)
Interest rate contracts	Interest and other income, net	0	4
Total		$ (51)	$ (63)

[1] Gains (losses) related to the ineffective portion of the hedges were not material in all periods presented.

The effect of derivative instruments in fair value hedging relationships on income is summarized below (in millions):

Derivatives in Fair Value Hedging Relationship	Gains (Losses) Recognized in Income on Derivatives[2] Income Statement Location	Three Months Ended March 31, 2013	2014
		(unaudited)	
Foreign exchange contracts	Interest and other income, net	$ 37	$ (2)
Hedged item	Interest and other income, net	(38)	0
Total		$ (1)	$ (2)

[2] Losses related to the amount excluded from effectiveness testing of the hedges were $1 million and $2 million for the three months ended March 31, 2013 and 2014.

The effect of derivative instruments not designated as hedging instruments on income is summarized below (in millions):

Derivatives Not Designated As Hedging Instruments	Gains (Losses) Recognized in Income on Derivatives Income Statement Location	Three Months Ended March 31, 2013	2014
		(unaudited)	
Foreign exchange contracts	Interest and other income, net, and net loss from discontinued operations	$ 87	$ (37)
Interest rate contracts	Interest and other income, net	0	1
Total		$ 87	$ (36)

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We present our derivatives, securities lending and reverse repurchase agreements at gross fair values in the Consolidated Balance Sheets. However, our master netting and other similar arrangements allow net settlements under certain conditions. As of December 31, 2013 and March 31, 2014, information related to these offsetting arrangements was as follows (in millions):

Offsetting of Assets

	As of December 31, 2013						
				Gross Amounts Not Offset in the Consolidated Balance Sheets, but Have Legal Rights to Offset			
Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Presented in the Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	Non-Cash Collateral Received	Net Assets Exposed
Derivatives	$232	$0	$232	$(2)[1]	$(35)	$(52)	$143
Reverse repurchase agreements	1,370	0	1,370[2]	0	0	(1,370)	0
Total	$1,602	$0	$1,602	$(2)	$(35)	$(1,422)	$143

	As of March 31, 2014						
				Gross Amounts Not Offset in the Consolidated Balance Sheets, but Have Legal Rights to Offset			
Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Presented in the Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	Non-Cash Collateral Received	Net Assets Exposed
	(unaudited)						
Derivatives	$84	$0	$84	$(5)[1]	$(7)	$(9)	$63
Reverse repurchase agreements	2,153	0	2,153[2]	0	0	(2,153)	0
Total	$2,237	$0	$2,237	$(5)	$(7)	$(2,162)	$63

(1) The balances at December 31, 2013 and March 31, 2014 were related to derivative liabilities which are allowed to be net settled against derivative assets in accordance with our master netting agreements.

(2) The balances at December 31, 2013 and March 31, 2014 included $1,270 million and $2,103 million recorded in cash and cash equivalents, respectively, and $100 million and $50 million recorded in receivable under reverse repurchase agreements, respectively.

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Offsetting of Liabilities

	As of December 31, 2013						
				Gross Amounts Not Offset in the Consolidated Balance Sheets, but Have Legal Rights to Offset			
Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Presented in the Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Non-Cash Collateral Pledged	Net Liabilities
Derivatives	$4	$ 0	$ 4	$(2)[3]	$0	$0	$2
Securities lending agreements	1,374	0	1,374	0	0	(1,357)	17
Total	$1,378	$ 0	$ 1,378	$(2)	$0	$(1,357)	$19

	As of March 31, 2014						
				Gross Amounts Not Offset in the Consolidated Balance Sheets, but Have Legal Rights to Offset			
Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Presented in the Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Non-Cash Collateral Pledged	Net Liabilities
	(unaudited)						
Derivatives	$18	$ 0	$ 18	$(5)[3]	$0	$0	$13
Securities lending agreements	2,153	0	2,153	0	0	(2,124)	29
Total	$2,171	$ 0	$ 2,171	$(5)	$0	$(2,124)	$42

(3) The balances at December 31, 2013 and March 31, 2014 were related to derivative assets which are allowed to be net settled against derivative liabilities in accordance with our master netting agreements.

Note 4. Debt

Short-Term Debt

We have a debt financing program of up to $3.0 billion through the issuance of commercial paper. Net proceeds from this program are used for general corporate purposes. At December 31, 2013 and March 31, 2014, we had $2.0 billion of outstanding commercial paper recorded as short-term debt with weighted-average interest rates of 0.1%. In conjunction with this program, we have a $3.0 billion revolving credit facility expiring in July 2016. The interest rate for the credit facility is determined based on a formula using certain market rates. At December 31, 2013 and March 31, 2014, we were in compliance with the financial covenant in the credit facility, and no amounts were outstanding under the credit facility at December 31, 2013 and March 31, 2014. The estimated fair value of the commercial paper approximated its carrying value at December 31, 2013 and March 31, 2014.

Our short-term debt balance also includes the short-term portion of certain long-term debt, as described in the section below.

Long-Term Debt

We issued $1.0 billion of unsecured senior notes (the "2014 Notes") in February 2014 and $3.0 billion of unsecured senior notes in three tranches (collectively, the "2011 Notes") in May 2011. We entered into a capital lease obligation in August 2013. The details of these financing arrangements are described in the table below (in millions):

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	As of December 31, 2013	As of March 31, 2014 (unaudited)
Short-Term Portion of Long-Term Debt		
1.25% Notes due on May 19, 2014	$1,000	$1,000
Capital Lease Obligation	9	9
Total	$1,009	$1,009
Long-Term Debt		
2.125% Notes due on May 19, 2016	$1,000	$1,000
3.625% Notes due on May 19, 2021	1,000	1,000
3.375% Notes due on February 25, 2024	0	1,000
Unamortized discount for the Notes above	(10)	(9)
Subtotal	1,990	2,991
Capital Lease Obligation	246	243
Total	$2,236	$3,234

The effective interest yields of the Notes due in 2014, 2016, 2021, and 2024 were 1.258%, 2.241%, 3.734% and 3.377%, respectively. Interest on the 2011 and 2014 Notes are payable semi-annually. The 2011 and 2014 Notes rank equally with each other with all of our other senior unsecured and unsubordinated indebtedness from time to time outstanding. We may redeem the 2011 and 2014 Notes at any time in whole or in part at specified redemption prices. We are not subject to any financial covenants under the 2011 Notes or the 2014 Notes. We used the net proceeds from the issuance of the 2011 Notes to repay a portion of our outstanding commercial paper and for general corporate purposes. We intend to use the net proceeds from the issuance of the 2014 Notes for general corporate purposes including the repayment of the principal amount of our 2011 Notes due on May 19, 2014. The total estimated fair value of the 2011 and 2014 Notes was approximately $3.1 billion and $4.1 billion at December 31, 2013 and March 31, 2014, respectively. The fair value of the 2011 and 2014 Notes was determined based on observable market prices of identical instruments in less active markets and is categorized accordingly as Level 2 in the fair value hierarchy.
In August 2013, we entered into a capital lease obligation on certain property expiring in 2028 with an option to purchase the property in 2016. The effective rate of the capital lease obligation approximates the market rate. The estimated fair value of the capital lease obligation approximated its carrying value at December 31, 2013 and March 31, 2014.

Note 5. Balance Sheet Components

Inventories

Inventories consisted of the following (in millions):

	As of December 31, 2013	As of March 31, 2014 (unaudited)
Raw materials and work in process	$115	$2
Finished goods	311	335
Inventories	$426	$337

Inventories to be disposed of as a result of the Motorola Mobile disposition were included in "Assets held for sale" on the Consolidated Balance Sheet as of March 31, 2014, and accordingly, are not included in this table.

Property and Equipment

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

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	As of December 31, 2013	As of March 31, 2014 (unaudited)
Information technology assets	$9,094	$9,408
Land and buildings	7,488	8,776
Construction in progress	5,602	5,878
Leasehold improvements	1,576	1,578
Furniture and fixtures	77	79
Total	23,837	25,719
Less: accumulated depreciation and amortization	7,313	7,842
Property and equipment, net	$16,524	$17,877

Property under capital lease with a cost basis of $258 million was included in land and buildings and construction in progress as of March 31, 2014. Additionally, property and equipment to be disposed of as a result of the Motorola Mobile disposition were included in "Assets held for sale" on the Consolidated Balance Sheet as of March 31, 2014, and accordingly, are not included in this table.

Accumulated Other Comprehensive Income (Loss)

The components of AOCI, net of tax, were as follows (in millions, unaudited):

	Foreign Currency Translation Adjustments	Unrealized Gains (Losses) on Available-for-Sale Investments	Unrealized Gains on Cash Flow Hedges	Total
Balance as of December 31, 2012	$(73)	$604	$7	$538
Other comprehensive income (loss) before reclassifications	(168)	(55)	109	(114)
Amounts reclassified from AOCI	0	(46)	(22)	(68)
Other comprehensive income (loss)	(168)	(101)	87	(182)
Balance as of March 31, 2013	$(241)	$503	$94	$356

	Foreign Currency Translation Adjustments	Unrealized Gains (Losses) on Available-for-Sale Investments	Unrealized Gains on Cash Flow Hedges	Total
Balance as of December 31, 2013	$16	$50	$59	$125
Other comprehensive income (loss) before reclassifications	65	217	10	292
Amounts reclassified from AOCI	0	(67)	(5)	(72)
Other comprehensive income (loss)	65	150	5	220
Balance as of March 31, 2014	$81	$200	$64	$345

The effects on net income of amounts reclassified from AOCI were as follows (in millions, unaudited):

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	Three Months Ended March 31, 2013	
AOCI Components	Location	Gains (Losses) Reclassified from AOCI to the Consolidated Statement of Income
Unrealized gains on available-for-sale investments	Interest and other income, net	$60
	Provision for income taxes	(14)
	Net of tax	$46
Unrealized gains on cash flow hedges for foreign exchange contracts	Revenue	$35
	Provision for income taxes	(13)
	Net of tax	$22
Total amount reclassified, net of tax		$68

	Three Months Ended March 31, 2014	
AOCI Components	Location	Gains (Losses) Reclassified from AOCI to the Consolidated Statement of Income
Unrealized gains on available-for-sale investments	Interest and other income, net	$74
	Provision for income taxes	(7)
	Net of tax	$67
Unrealized gains on cash flow hedges for foreign exchange contracts	Revenue	$8
	Provision for income taxes	(3)
	Net of tax	$5
Total amount reclassified, net of tax		$72

Note 6. Acquisitions

In February 2014, we completed the acquisition of Nest Labs, Inc. (Nest), a company whose mission is to reinvent devices in the home such as thermostats and smoke alarms. Prior to this transaction, we had an approximately 12% ownership interest in Nest. The acquisition is expected to enhance Google's suite of products and services and allow Nest to continue to innovate upon devices in the home, making them more useful, intuitive, and thoughtful, and to reach more users in more countries.

The fair value of assets acquired and liabilities assumed was recorded based on a preliminary valuation and our estimates and assumptions are subject to change within the measurement period. The primary areas of the purchase price allocation that are not yet finalized are related to the fair values of intangible assets acquired, certain income taxes and residual goodwill. Of the total $2.5 billion purchase price and the fair value of our previously held equity interest of $152 million, $51 million was cash acquired, $430 million was attributed to intangible assets, $2.35 billion was attributed to goodwill, and $157 million was attributed to net liabilities assumed. The goodwill of $2.35 billion is primarily attributable to the synergies expected to arise after the acquisition. Goodwill is not expected to be deductible for tax purposes.

This transaction is considered a “step acquisition” under GAAP whereby our ownership interest in Nest held before the acquisition is required to be remeasured to fair value at the date of the acquisition. Such fair value was estimated by using discounted cash flow valuation methodologies. Inputs used in the methodologies primarily

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included projected future cash flows, discounted at a rate commensurate with the risk involved. The gain of $103 million as a result of remeasurement is included in “interest and other income, net” on our Consolidated Statement of Income.
During the three months ended March 31, 2014, we completed other acquisitions and purchases of intangible assets for a total cash consideration of approximately $483 million, of which $50 million was cash acquired, $33 million was attributed to intangible assets, $404 million to goodwill, and $4 million to net liabilities assumed. These acquisitions generally enhance the breadth and depth of our expertise in engineering and other functional areas, our technologies, and our product offerings. Goodwill is not expected to be deductible for tax purposes.
Pro forma results of operations for these acquisitions have not been presented because they are not material to the consolidated results of operations, either individually or in aggregate.
For all acquisitions completed during the three months ended March 31, 2014, patents and developed technology have a weighted-average useful life of 5.7 years, customer relationships have a weighted-average useful life of 5.0 years, and trade names and other have a weighted-average useful life of 7.9 years.

Note 7. Goodwill and Other Intangible Assets
The changes in the carrying amount of goodwill for the three months ended March 31, 2014 were as follows (in millions, unaudited):

Balance as of December 31, 2013	$11,492
Goodwill acquired	2,754
Goodwill reclassified to assets held for sale	(71)
Goodwill adjustment	2
Balance as of March 31, 2014	$14,177

Information regarding our acquisition-related intangible assets was as follows (in millions):

	As of December 31, 2013		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Patents and developed technology	$7,282	$2,102	$5,180
Customer relationships	1,770	1,067	703
Trade names and other	534	351	183
Total	$9,586	$3,520	$6,066

	As of March 31, 2014		
	Gross Carrying Amount (unaudited)	Accumulated Amortization	Net Carrying Value
Patents and developed technology	$6,825	$2,158	$4,667
Customer relationships	1,390	1,033	357
Trade names and other	640	347	293
Total	$8,855	$3,538	$5,317

Goodwill and Intangible Assets to be disposed of as a result of our Motorola Mobile disposition were included in "Assets held for sale" on the Consolidated Balance Sheet as of March 31, 2014 and accordingly, are not included in the table above. Amortization of these intangible assets were stopped as of the date they were deemed to be held for sale.

Amortization expense relating to acquisition-related intangible assets was $279 million and $270 million for the three months ended March 31, 2013 and 2014.

As of March 31, 2014, expected amortization expense relating to acquisition-related intangible assets for each of the next five years and thereafter was as follows (in millions, unaudited):

Remainder of 2014	$758
2015	859
2016	772
2017	705
2018	653
Thereafter	1,570
	$5,317

Note 8. Discontinued Operations

Motorola Mobile

On January 29, 2014, we entered into an agreement with Lenovo providing for the disposition of the Motorola Mobile business for a total purchase price of approximately $2.9 billion (subject to certain adjustments), including $1.4 billion to be paid at close, comprised of $660 million in cash and $750 million in Lenovo ordinary shares (subject to a share cap and floor). The remaining $1.5 billion will be paid in the form of an interest-free, three-year prepayable promissory note.

We will maintain ownership of the vast majority of the Motorola Mobile patent portfolio, including current patent applications and invention disclosures, which will be licensed back to Motorola Mobile for its continued operations. Additionally, in connection with the sale, we will indemnify Lenovo for certain potential liabilities of the Motorola Mobile business. The transaction is subject to the satisfaction of regulatory requirements, customary closing conditions and any other needed approvals and is expected to close in 2014.

As such, financial results of Motorola Mobile are presented as net loss from discontinued operations on the Consolidated Statements of Income for the three months ended March 31, 2013 and 2014; and assets and liabilities of Motorola Mobile to be disposed of are presented as assets held for sale and liabilities held for sale on the Consolidated Balance Sheet as of March 31, 2014, respectively.

The following table presents financial results of the Motorola Mobile business included in net loss from discontinued operations for the three months ended March 31, 2013 and 2014 (in millions, unaudited):

	Three Months Ended March 31,	
	2013	2014
Revenues	$1,018	$1,377
Loss from discontinued operations before income taxes	(271)	(274)
Benefits from income taxes	67	76
Net loss from discontinued operations	$(204)	$(198)

The following table presents the aggregate carrying amounts of the major classes of assets and liabilities related to the Motorola Mobile business to be disposed of as of March 31, 2014 (in millions, unaudited):

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Assets:	
Cash and cash equivalents	$160
Accounts receivable	881
Inventories	85
Prepaid expenses and other current assets	956
Prepaid expenses and other assets, non-current	270
Property and equipment, net	503
Intangible assets, net	947
Goodwill	71
Total assets	$3,873
Liabilities:	
Accounts payable	$1,039
Accrued compensation and benefits	137
Accrued expenses and other current liabilities	450
Deferred revenue	154
Other long-term liabilities	248
Total liabilities	$2,028

Motorola Home

In December 2012, we entered into an agreement with Arris and certain other persons providing for the disposition of the Motorola Home business. The transaction closed on April 17, 2013. As such, financial results of Motorola Home were included in net loss from discontinued operations for the three months ended March 31, 2013.

The following table presents financial results of the Motorola Home business included in net loss from discontinued operations for the three months ended March 31, 2013 (in millions, unaudited):

	Three Months Ended March 31, 2013
Revenues	$738
Income from discontinued operations before income taxes	47
Provision for income taxes	(25)
Net income from discontinued operations	$22

Note 9. Restructuring Charges

Subsequent to our acquisition of Motorola Mobility Holdings, Inc. (Motorola) in May 2012, we initiated a restructuring plan for Motorola, primarily in our Motorola Mobile business, to reduce workforce, reorganize management structure, close or consolidate certain facilities, as well as simplify our mobile product portfolio. These changes are designed to return the Motorola Mobile business to profitability. Pursuant to this restructuring plan, we have incurred cumulative charges of approximately $824 million.

For the three months ended March 31, 2014, changes to restructuring accruals were as follows (in millions, unaudited):

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	Severance and Related	Other Charges	Total
Balance as of December 31, 2013	$45	$12	$57
Charges	5	(2)	3
Cash payments	(17)	(2)	(19)
Balance as of March 31, 2014	$33	$8	$41

For the three months ended March 31, 2013 and 2014, restructuring charges totaled $63 million and $3 million, which were included in net loss from discontinued operations on the Consolidated Statements of Income.

Note 10. Interest and Other Income, Net

The components of interest and other income, net, were as follows (in millions, unaudited):

	Three Months Ended March 31,	
	2013	2014
Interest income	$180	$168
Interest expense	(21)	(24)
Realized gains on available-for-sale investments, net	60	74
Foreign currency exchange losses, net	(61)	(109)
Realized gain on equity interest	0	103
Realized gain on non-marketable equity investments	0	117
Other income (expense), net	(24)	28
Interest and other income, net	$134	$357

Note 11. Contingencies

Legal Matters

Antitrust Investigations

On November 30, 2010, the European Commission's (EC) Directorate General for Competition opened an investigation into various antitrust-related complaints against us. We believe we have adequately responded to all of the allegations made against us. We continue to cooperate with the EC and are pursuing a potential resolution that would avoid a finding of infringement and a fine. The EC has also opened an investigation into Motorola's licensing practices for standards essential patents and use of standards-essential patents in litigation on the basis of complaints brought by Microsoft and Apple. The EC has issued a Statement of Objections against Motorola alleging abuse of a dominant position with respect to these standards-essential patents. We have responded to the Statement of Objections and are defending the case.

The Comision Nacional de Defensa de la Competencia in Argentina, the Competition Commission of India, the Taiwan Fair Trade Commission, Brazil's Council for Economic Defense and the Canadian Competition Bureau have also opened investigations into certain of our business practices.

State attorneys general from the states of Texas, Ohio, and Mississippi have also issued Civil Investigative Demands relating to our business practices. We are cooperating with the state attorneys general and are responding to their information requests on an ongoing basis.

Patent and Intellectual Property Claims

We have had patent, copyright, and trademark infringement lawsuits filed against us claiming that certain of our products, services, and technologies, including Android, Google Search, Google AdWords, Google AdSense, Google Books, Google News, Google Image Search, Google Chrome, Google Talk, Google Voice, Motorola devices and YouTube, infringe the intellectual property rights of others. Adverse results in these lawsuits may include awards of substantial monetary damages, costly royalty or licensing agreements, or orders preventing us from offering certain

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features, functionalities, products, or services, and may also cause us to change our business practices, and require development of non-infringing products or technologies, which could result in a loss of revenues for us and otherwise harm our business. In addition, the U.S. International Trade Commission (ITC) has increasingly become an important forum to litigate intellectual property disputes because an ultimate loss for a company or its suppliers in an ITC action could result in a prohibition on importing infringing products into the U.S. Since the U.S. is an important market, a prohibition on importation could have an adverse effect on us, including preventing us from importing many important products into the U.S. or necessitating workarounds that may limit certain features of our products.
Furthermore, many of our agreements with our customers and partners require us to indemnify them for certain intellectual property infringement claims against them, which would increase our costs as a result of defending such claims, and may require that we pay significant damages if there were an adverse ruling in any such claims. Our customers and partners may discontinue the use of our products, services, and technologies, as a result of injunctions or otherwise, which could result in loss of revenues and adversely impact our business.

Other

We are also regularly subject to claims, suits, government investigations, and other proceedings involving competition and antitrust (such as the pending investigation by the EC described above), intellectual property, privacy, tax, labor and employment, commercial disputes, content generated by our users, goods and services offered by advertisers or publishers using our platforms, personal injury, consumer protection, and other matters. Such claims, suits, government investigations, and other proceedings could result in fines, civil or criminal penalties, or other adverse consequences.

Certain of our outstanding legal matters include speculative claims for substantial or indeterminate amounts of damages. We record a liability when we believe that it is probable that a loss has been incurred and the amount can be reasonably estimated. We evaluate, on a monthly basis, developments in our legal matters that could affect the amount of liability that has been previously accrued, and make adjustments as appropriate. Significant judgment is required to determine both likelihood of there being and the estimated amount of a loss related to such matters.

With respect to our outstanding legal matters, based on our current knowledge, we believe that the amount or range of reasonably possible loss will not, either individually or in the aggregate, have a material adverse effect on our business, consolidated financial position, results of operations, or cash flows. However, the outcome of such legal matters is inherently unpredictable and subject to significant uncertainties.

We expense legal fees in the period in which they are incurred.

Taxes

We are under audit by the Internal Revenue Service (IRS) and various other tax authorities with regards to income tax and indirect tax matters. We have reserved for potential adjustments to our provision for income taxes and accrual of indirect taxes that may result from examinations by, or any negotiated agreements with, these tax authorities, and we believe that the final outcome of these examinations or agreements will not have a material effect on our results of operations. If events occur which indicate payment of these amounts is unnecessary, the reversal of the liabilities would result in the recognition of benefits in the period we determine the liabilities are no longer necessary. If our estimates of the federal, state, and foreign income tax liabilities and indirect tax liabilities are less than the ultimate assessment, it would result in a further charge to expense.

In March 2014, we received a tax assessment from the French tax authorities. We believe an adequate provision has been made and it is more likely than not that our tax position will be sustained. However, it is reasonably possible that resolution with the French tax authorities could result in an adjustment to our tax position.

Note 12. Stockholders' Equity

The following table presents the weighted-average assumptions used to estimate the fair values of the stock options granted in the periods presented. The weighted average estimated fair value of options granted has been retroactively adjusted to reflect the effects of the two-for-one stock split:

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	Three Months Ended March 31,	
	2013	2014
	(unaudited)	
Risk-free interest rate	0.9%	N/A
Expected volatility	29%	N/A
Expected life (in years)	5.8	N/A
Dividend yield	0%	N/A
Weighted-average estimated fair value of options granted during the period	$107.20	N/A

There were 3,142 (split-adjusted) stock options granted during the three months ended March 31, 2013. No options were granted during the three months ended March 31, 2014.

The following table summarizes the activities for our stock options for the three months ended March 31, 2014 and has been retroactively adjusted to reflect the effects of the two-for-one stock split:

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions) [(1)]
	(unaudited)			
Balance as of December 31, 2013	10,065,726	$215.50		
Granted	—	$—		
Exercised	(1,301,382)	$205.35		
Forfeited/canceled	(15,686)	$280.01		
Balance as of March 31, 2014	8,748,658	$217.04	5.1	$ 2,977
Exercisable as of March 31, 2014	6,570,910	$190.39	4.4	$ 2,411
Exercisable as of March 31, 2014 and expected to vest thereafter [(2)]	8,480,795	$214.50	5.1	$ 2,907

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the split adjusted closing stock price of $557.26 for our Class A common stock on March 31, 2014.
(2) Options expected to vest reflect an estimated forfeiture rate.

As of March 31, 2014, there was $154 million of unrecognized compensation cost related to outstanding Google employee stock options. This amount is expected to be recognized over a weighted-average period of 1.7 years. To the extent the actual forfeiture rate is different from what we have estimated, stock-based compensation related to these awards will be different from our expectations.
The following table summarizes the activities for our unvested RSUs for the three months ended March 31, 2014 and has been retroactively adjusted to reflect the effects of the two-for-one stock split:

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	Unvested Restricted Stock Units	
	Number of Shares	Weighted-Average Grant-Date Fair Value
	(unaudited)	
Unvested as of December 31, 2013	21,953,960	$ 359.20
Granted	1,905,174	$ 594.91
Vested	(2,436,424)	$ 325.73
Forfeited/canceled	(219,832)	$ 352.58
Unvested as of March 31, 2014	21,202,878	$ 384.31
Expected to vest after March 31, 2014 (1)	18,594,924	$ 384.31

(1) RSUs expected to vest reflect an estimated forfeiture rate.

As of March 31, 2014, there was $6.3 billion of unrecognized compensation cost related to unvested Google employee RSUs. This amount is expected to be recognized over a weighted-average period of 2.8 years. To the extent the actual forfeiture rate is different from what we have estimated, stock-based compensation related to these awards will be different from our expectations.

Stock Split Effected In Form of Stock Dividend

In April 2012, our board of directors approved amendments to our certificate of incorporation that created a new class of non-voting capital stock (Class C capital stock). The amendments authorized 3 billion shares of Class C capital stock and also increased the authorized shares of Class A common stock from 6 billion to 9 billion. The amendments are reflected in our Fourth Amended and Restated Certificate of Incorporation (New Charter), the adoption of which was approved by stockholders at our 2012 Annual Meeting of Stockholders held on June 21, 2012. In January 2014, our board of directors approved a distribution of shares of the Class C capital stock as a dividend to our holders of Class A and Class B common stock. The Stock Split had a record date of March 27, 2014 and a payment date of April 2, 2014.

Share and per-share amounts disclosed as of March 31, 2014 and for all other comparative periods provided have been retroactively adjusted to reflect the effects of the stock split. The Class C capital stock has no voting rights, except as required by applicable law. Except as expressly provided in the New Charter, shares of Class C capital stock have the same rights and privileges and rank equally, share ratably and are identical in all other respects to the shares of Class A common stock and Class B common stock as to all matters including dividend and distribution rights.

In accordance with the settlement of litigation involving the authorization to distribute the Class C capital stock, we may be obligated to make a payment to holders of the Class C stock if, on average, Class C trades below Class A during the first 365 days following the Class C issuance, payable in cash, Class A stock, Class C stock, or a combination thereof, at the discretion of the board of directors. As the Class C shares were only recently issued, we cannot reliably predict what, if any, patterns will emerge over time with respect to the relative trading prices of Class A and Class C shares.

The par value per share of our shares of Class A common stock and Class B common stock remained unchanged at $0.001 per share after the Stock Split. On the effective date of the Stock Split, a transfer between retained earnings and common stock occurred and the amount transferred was equal to the $0.001 par value of the Class C capital stock that was issued.

Note 13. Income Taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. Our total unrecognized tax benefits were $2,571 million and $2,764 million as of December 31, 2013 and March 31, 2014. Our total unrecognized tax benefits that, if recognized, would affect our effective tax rate were $2,378 million and $2,557 million as of December 31, 2013 and March 31, 2014. Our existing tax positions will continue to generate an increase in liabilities for unrecognized tax benefits.

Our provision for income taxes and effective tax rate increased from the three months ended March 31, 2013 to the three months ended March 31, 2014, largely attributed to the expiration of the federal research and development credit as of December 31, 2013.

Our effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected to the extent earnings are lower than anticipated in countries that have lower statutory rates and higher than anticipated in countries that have higher statutory rates. Our effective tax rate could also fluctuate due to the net gains and losses recognized by legal entities on certain hedges and related hedged intercompany and other transactions under our foreign exchange risk management program, by changes in the valuation of our deferred tax assets or liabilities, or by changes in tax laws, regulations, or accounting principles, as well as certain discrete items. In addition, we are subject to the continuous examination of our income tax returns by the IRS and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Note 14. Information about Segments and Geographic Areas

On January 29, 2014, we entered into an agreement with Lenovo providing for the disposition of the Motorola Mobile business. Financial results of Motorola Mobile are included in net loss from discontinued operations for the three months ended March 31, 2013 and 2014. As such, Motorola Mobile is not presented as a separate segment in our segment report.

Revenues by geography are based on the billing addresses of our customers. The following tables set forth revenues and long-lived assets by geographic area (in millions):

	Three Months Ended March 31,	
	2013	2014
	(unaudited)	
Revenues:		
United States	$5,836	$6,656
United Kingdom	1,387	1,583
Rest of the world	5,728	7,181
Total revenues	$12,951	$15,420

	As of December 31, 2013	As of March 31, 2014 (unaudited)
Long-lived assets:		
United States	$24,004	$27,159
International	14,030	14,053
Total long-lived assets	$38,034	$41,212

Long-lived assets to be disposed of as a result of our Motorola Mobile disposition were included in "Assets held for sale" on the Consolidated Balance Sheet as of March 31, 2014, and accordingly, are not included in this table.

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

The following discussion and analysis of our financial condition and results of operations should be read together with our consolidated financial statements and related notes included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

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Overview

Google is a global technology leader focused on improving the ways people connect with information. We aspire to build products and provide services that improve the lives of billions of people globally. Our mission is to organize the world's information and make it universally accessible and useful. Our innovations in web search and advertising have made our website a top internet property and our brand one of the most recognized in the world. Google generates revenues primarily by delivering relevant, cost-effective online advertising. Businesses use our AdWords program and AdSense program to promote their products and services with advertising on both Google-owned properties and publishers' sites across the web.

In January 2014, we entered into an agreement with Lenovo Group Limited (Lenovo) providing for the disposition of the Motorola Mobile business. The transaction is expected to close in 2014. As such, financial results of Motorola Mobile are presented as "Net loss from discontinued operations" on the Consolidated Statements of Income for the three months ended March 31, 2013 and 2014; and assets and liabilities of Motorola Mobile to be disposed of are presented as "Assets held for sale" and "Liabilities held for sale" on the Consolidated Balance Sheet as of March 31, 2014, respectively. The Motorola Mobile business is focused on mobile wireless devices and related products and services and generates revenues primarily by selling hardware products.

In December 2012, we entered into an agreement for the disposition of the Motorola Home business. The transaction closed on April 17, 2013. Financial results related to Motorola Home were included within net loss from discontinued operations on the Consolidated Statements of Income for the three months ended March 31, 2013. The Motorola Home business was focused on technologies and devices that provide video entertainment services to consumers by enabling subscribers to access a variety of interactive digital television services.

Trends in Our Businesses

Advertising transactions continue to shift from offline to online as the digital economy evolves. This has contributed to the rapid growth of our business since inception, resulting in substantially increased revenues, and we expect that our business will continue to grow. However, our revenue growth rate has generally declined over time, and it could do so in the future as a result of a number of factors, including increasing competition, our investments in new business strategies, products, services, and technologies, changes in our product mix, shifts in the geographic mix of our revenues, query growth rates and how users make queries, challenges in maintaining our growth rate as our revenues increase to higher levels, and the evolution of the online advertising market, including the increasing variety of online platforms for advertising, and other markets in which we participate.

Our users are increasingly connected to the internet and using multiple devices to access our products and services, a trend that has increased our global search queries and changed our platform mix. We expect that our revenue growth rate will continue to be affected by evolving consumer preferences, as well as by advertising trends, the acceptance by users of our products and services as they are delivered on diverse devices, and our ability to create a seamless experience for both users and advertisers in this multi-screen environment.

The main focus of our advertising programs is to help businesses reach people in the moments that matter across all devices with smarter ads that are relevant to their intent and context, reflecting our commitment to constantly improve their overall web experience. As a result, we expect to continue to take steps to improve the relevance of the ads displayed on our websites and our Google Network Members' websites. These steps include not displaying ads that generate low click-through rates or that send users to irrelevant or otherwise low-quality websites, updating our advertising policies and ensuring their compliance, and terminating our relationships with those Google Network Members whose websites do not meet our quality requirements. We may also continue to take steps to reduce the number of accidental clicks by our users. These steps could negatively affect the growth rate of our revenues.

Both seasonal fluctuations in internet usage and traditional retail seasonality have affected, and are likely to continue to affect, our business. Internet usage generally slows during the summer months, and commercial queries typically increase significantly in the fourth quarter of each year. These seasonal trends have caused, and will likely continue to cause, fluctuations in our quarterly results, including fluctuations in sequential revenues, as well as aggregate paid clicks and average cost-per-click growth rates.

The operating margin we realize on revenues generated from ads placed on our Google Network Members' websites through our AdSense program is significantly lower than the operating margin we realize from revenues generated from ads placed on our websites because most of the advertiser fees from ads served on Google Network Members' websites are shared with our Google Network Members. For the past five years, growth in advertising revenues from our websites has generally exceeded that from our Google Network Members' websites. This trend has had a positive impact on our operating margins, and we expect that this will continue for the foreseeable future, although the relative rate of growth in revenues from our websites compared to the rate of growth in revenues from our Google Network Members' websites may vary over time. Also, the margins on advertising revenues from mobile phones and other newer advertising formats are generally lower than those from desktop computers and tablets. We expect this trend to continue to pressure our margins, particularly if we fail to realize the opportunities we anticipate with the transition to a dynamic multi-screen environment.

We conduct our Motorola Mobile business in highly competitive markets, facing both new and established competitors. The markets for many of our products are characterized by rapidly changing technologies, frequent new product introductions, changing consumer trends, short product life cycles, consumer loyalty and evolving industry standards. Market disruptions caused by new technologies, the entry of new competitors, consolidations among our customers and competitors, changes in regulatory requirements, changes in economic conditions, supply chain interruptions or other factors, can introduce volatility into our businesses. Meeting all of these challenges requires consistent operational planning and execution and investment in technology, resulting in innovative products that meet the needs of our customers around the world.

From an overall business perspective, we continue to invest aggressively in areas of strategic focus, our systems, data centers, corporate facilities, information technology infrastructure, and employees. We expect to continue to hire aggressively for the remainder of 2014 and provide competitive compensation programs to our employees. Our full-time employee headcount was 53,891 (including 9,982 headcount from Motorola Mobile and 5,170 from Motorola Home) at March 31, 2013, and 49,829 (which includes 3,659 headcount from Motorola Mobile) at March 31, 2014. Acquisitions will also remain an important component of our strategy and use of capital. We expect our cost of revenues will increase in dollars and may increase as a percentage of revenues in future periods, primarily as a result of forecasted increases in traffic acquisition costs, manufacturing and inventory-related costs, data center costs, content acquisition costs, credit card and other transaction fees, and other costs. In particular, traffic acquisition costs as a percentage of advertising revenues may increase in the future if we are unable to continue to improve the monetization or generation of revenues from traffic on our websites and our Google Network Members' websites.

As we expand our advertising programs and other products to international markets, we continue to increase our exposure to fluctuations in foreign currency to U.S. dollar exchange rates. We have a foreign exchange risk management program that is designed to reduce our exposure to fluctuations in foreign currency exchange rates. However, this program will not fully offset the effect of fluctuations on our revenues and earnings.

Other revenues consist of non-advertising revenues including licensing, hardware and digital content. We expect other revenues to continue to grow. However, operating margin on other revenues is generally lower than that on advertising revenues.

Results of Operations

We completed our acquisition of Motorola on May 22, 2012 (the acquisition date). In December 2012, we entered into an agreement for the disposition of the Motorola Home business, and consequently, financial results related to Motorola Home were presented as net income (loss) from discontinued operations in the Consolidated Statements of Income. In April 2013, we completed the disposition of the Motorola Home business.

In January 2014, we entered into an agreement with Lenovo providing for the disposition of the Motorola Mobile business. The transaction is expected to close in 2014. As such, financial results of Motorola Mobile are presented as "Net loss from discontinued operations" on the Consolidated Statements of Income for the three months ended March 31, 2013 and 2014; and assets and liabilities of Motorola Mobile to be disposed of are presented as "Assets held for sale" and "Liabilities held for sale" on the Consolidated Balance Sheet as of March 31, 2014, respectively.

The following table presents our historical operating results as a percentage of revenues for the periods presented:

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	Three Months Ended March 31,			
	2013		2014	
	(unaudited)			
Consolidated Statements of Income Data:				
Revenues	100	%	100	%
Costs and expenses:				
Cost of revenues	39.7		38.7	
Research and development	12.5		13.8	
Sales and marketing	11.1		11.2	
General and administrative	7.8		9.6	
Total costs and expenses	71.1		73.3	
Income from operations	28.9		26.7	
Interest and other income, net	1.0		2.3	
Income from continuing operations before income taxes	29.9		29.0	
Provision for income taxes	2.7		5.3	
Net income from continuing operations	27.2		23.7	
Net loss from discontinued operations	(1.4	)	(1.3	)
Net income	25.8	%	22.4	%

Revenues

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

	Three Months Ended March 31,	
	2013	2014
	(unaudited)	
Advertising revenues:		
Websites	$8,640	$10,469
Network Members' websites	3,262	3,397
Total advertising revenues	11,902	13,866
Other revenues	1,049	1,554
Total revenues	$12,951	$15,420

The following table presents our revenues, by revenue source, as a percentage of revenues for the periods presented:

	Three Months Ended March 31,			
	2013		2014	
	(unaudited)			
Advertising revenues:				
Websites	66.7	%	67.9	%
Network Members' websites	25.2		22.0	
Total advertising revenues	91.9	%	89.9	%
Websites as % of advertising revenues	72.6		75.5	
Network Members’ websites as % of advertising revenues	27.4		24.5	
Other revenues	8.1	%	10.1	%

Our revenues increased $2,469 million from the three months ended March 31, 2013 to the three months ended March 31, 2014. This increase resulted primarily from an increase in advertising revenues generated by Google websites and an increase in other revenues, and to a lesser extent, an increase in advertising revenues generated by Google Network Members' websites. The increase in other revenues was mainly driven by higher sales related to digital content and hardware products. The increase in advertising revenues for Google websites and Google Network Members' websites resulted primarily from an increase in the number of paid clicks through our advertising programs, as paid clicks on Google websites and Google Network Members' websites increased approximately 26% from the three months ended March 31, 2013 to the three months ended March 31, 2014. The increase in the number of paid clicks generated through our advertising programs was due to certain monetization improvements including new and richer ad formats, an increase in aggregate traffic across all platforms, the continued global expansion of our products, advertisers, and user base, as well as an increase in the number of Google Network Members, partially offset by certain advertising policy changes. The impact from the increase in paid clicks on our revenue growth was partially offset by a decrease in the average cost-per-click paid by our advertisers. Average cost-per-click on Google websites and Google Network Members' websites decreased approximately 9% from the three months ended March 31, 2013 to the three months ended March 31, 2014. The decrease in the average cost-per-click paid by our advertisers was driven by various factors, such as the introduction of new products as well as changes in property mix, platform mix and geographical mix, and the general strengthening of the U.S. dollar compared to certain foreign currencies.

The rate of change in aggregate paid clicks and average cost-per-click, and their correlation with the rate of change in revenues, has fluctuated and may fluctuate in the future because of various factors, including the revenue growth rates on our websites compared to those of our Google Network Members, advertiser competition for keywords, changes in foreign currency exchange rates, seasonality, the fees advertisers are willing to pay based on how they manage their advertising costs, changes in advertising quality or formats, and general economic conditions. In addition, traffic growth in emerging markets compared to more mature markets and across various advertising verticals and channels also contributes to these fluctuations. Changes in aggregate paid clicks and average cost-per-click may not be indicative of our performance or advertiser experiences in any specific geographic market, vertical, or industry.

Improvements in our ability to monetize increased traffic primarily relate to enhancing the end user experience, including providing end users with ads that are more relevant to their search queries or to the content on the Google Network Members’ websites they visit. For instance, these improvements include displaying advertiser-nominated images that are relevant to the user query and creating a more engaging user shopping experience by enhancing search ads to include richer product information, such as product image, price, and merchant name. We believe that the increase in the number of paid clicks on Google websites and Google Network Members’ websites is substantially the result of our commitment to improving the relevance and quality of both our search results and the advertisements displayed, which we believe results in a better user experience, which in turn results in more searches, advertisers, Google Network Members and other partners.

Other revenues increased $505 million from the three months ended March 31, 2013 to the three months ended March 31, 2014 and also increased as a percentage of total revenues. The increase was primarily due to growth of our digital content products, such as apps, music and movies, and to a lesser extent, an increase in our hardware revenues.

Revenues by Geography

The following table presents our domestic and international revenues as a percentage of total revenues, determined based on the billing addresses of our customers:

	Three Months Ended March 31,			
	2013		2014	
	(unaudited)			
United States	45	%	43	%
United Kingdom	11	%	10	%
Rest of the world	44	%	47	%

The growth in revenues from the rest of the world as a percentage of total revenues from the three months ended March 31, 2013 to the three months ended March 31, 2014 resulted largely from increased acceptance of our advertising programs, and our continued progress in developing localized versions of our products for the international markets.

Foreign Exchange Impact on Revenues

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The general strengthening of the U.S. dollar relative to certain foreign currencies (primarily the Japanese yen, Australian dollar, and Brazilian real) from the three months ended March 31, 2013 to the three months ended March 31, 2014 had an unfavorable impact on our international revenues, which was partially offset by the general weakening of the U.S. dollar relative to other foreign currencies (primarily the Euro). Had foreign exchange rates remained constant in these periods, our revenues from the United Kingdom would have been $71 million or 4% lower and our revenues from the rest of the world would have been approximately $234 million or 3% higher in the three months ended March 31, 2014. This is before consideration of hedging gains $8 million recognized to revenues from the rest of the world in the three months ended March 31, 2014.

Although we expect to continue to make investments in international markets, these investments may not result in an increase in our international revenues as a percentage of total revenues in the remainder of 2014 or thereafter. See Note 14 of Notes to Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional information about geographic areas.

Costs and Expenses

Cost of Revenues

Cost of revenues consists primarily of traffic acquisition costs. Traffic acquisition costs consist of amounts paid to our Google Network Members under AdSense arrangements and to certain other partners (our distribution partners) who distribute our toolbar and other products (collectively referred to as access points) or otherwise direct search queries to our website (collectively referred to as distribution arrangements). These amounts are primarily based on the revenue share and fixed fee arrangements with our Google Network Members and distribution partners.

Certain distribution arrangements require us to pay our partners based on a fee per access point delivered and not exclusively -- or at all -- based on revenue share. These fees are non-refundable. Further, these arrangements are terminable at will, although under the terms of certain contracts we or our distribution partners may be subject to penalties in the event of early termination. We recognize fees under these arrangements over the estimated useful lives of the access points to the extent we can reasonably estimate those lives and they are one year or longer, or based on any contractual revenue share, if greater. Otherwise, the fees are charged to expense as incurred. The estimated useful life of the access points is based on the historical average period of time they generate traffic and revenues.

Cost of revenues also includes the expenses associated with the operation of our data centers, including depreciation, labor, energy, and bandwidth costs; hardware inventory costs; credit card and other transaction fees related to processing customer transactions; amortization of acquisition-related intangible assets; and content acquisition costs. We have entered into arrangements with certain content providers under which we distribute or license their video and other content. In a number of these arrangements, we display ads on the pages of our websites from which the content is viewed and share most of the fees these ads generate with the content providers. We also license content on the pages of our websites from which the content is sold and share most of the fees these sales generate with content providers. To the extent we are obligated to make guaranteed minimum revenue share payments to our content providers, we recognize as content acquisition costs the contractual revenue share amount or the amount determined on a straight-line basis, whichever is greater, over the term of the agreements.

The following tables present our cost of revenues and cost of revenues as a percentage of revenues, and our traffic acquisition costs and traffic acquisition costs as a percentage of advertising revenues, for the periods presented (dollars in millions):

	Three Months Ended March 31,			
	2013		2014	
	(unaudited)			
Cost of revenues	$5,136		$5,961	
Cost of revenues as a percentage of revenues	39.7	%	38.7	%

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	Three Months Ended March 31, 2013 (unaudited)	2014
Traffic acquisition costs related to AdSense arrangements	$2,282	$2,387
Traffic acquisition costs related to distribution arrangements	680	845
Traffic acquisition costs	$2,962	$3,232
Traffic acquisition costs as a percentage of advertising revenues	24.9 %	23.3 %

Cost of revenues increased $825 million from the three months ended March 31, 2013 to the three months ended March 31, 2014. The increase was due to increases in traffic acquisition costs of $270 million resulting from more distribution fees paid, more fees paid for additional traffic directed to our websites, as well as more advertiser fees generated through our AdSense program driven primarily by an increase in advertising revenues. The remaining increase was primarily driven by an increase in data center costs, content acquisition costs as a result of increased activities related to YouTube and digital content, revenue share payments to mobile carriers and original equipment manufacturers (OEMs), and hardware inventory costs as a result of increased hardware sales. The decrease in traffic acquisition costs as a percentage of advertising revenues was primarily as a result of a shift of mix between Google website revenue and Google Network Members' websites.

We expect cost of revenues will increase in dollar amount and may increase as a percentage of total revenues in the remainder of 2014 and in future periods, primarily as a result of increases in traffic acquisition costs, data center costs, hardware inventory costs, content acquisition costs, credit card and other transaction fees, and other costs. Traffic acquisition costs as a percentage of advertising revenues may fluctuate in the future based on a number of factors, including the following:

- The relative growth rates of revenues from our websites and from our Google Network Members’ websites.
- Whether we are able to enter into more AdSense arrangements that provide for lower revenue share obligations or whether increased competition for arrangements with existing and potential Google Network Members results in less favorable revenue share arrangements.
- Whether we are able to continue to improve the monetization of traffic on our websites and our Google Network Members’ websites.
- The relative growth rates of expenses associated with distribution arrangements and the related revenues generated, including whether we share with certain existing and new distribution partners proportionately more of the aggregate advertising fees that we earn from paid clicks derived from search queries these partners direct to our websites.

Research and Development

The following table presents our research and development expenses, and research and development expenses as a percentage of revenues, for the periods presented (dollars in millions):

	Three Months Ended March 31, 2013 (unaudited)	2014
Research and development expenses	$1,617	$2,126
Research and development expenses as a percentage of revenues	12.5 %	13.8 %

Research and development expenses consist primarily of compensation and related costs for personnel responsible for the research and development activities relating to new and existing products and services, as well as depreciation and equipment-related costs. We expense research and development costs as incurred.

Research and development expenses increased $509 million and also increased as a percentage of revenues from the three months ended March 31, 2013 to the three months ended March 31, 2014. The increase was primarily due to an increase in labor and facilities-related costs of $243 million, largely as a result of a 23% increase in research and development headcount during the three months ended March 31, 2014, an increase in stock-based compensation expense of $117 million, and an increase in depreciation and equipment-related expenses of $79 million.

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We expect that research and development expenses will increase in dollar amount and may increase as a percentage of revenues in the remainder of 2014 and future periods because we expect to continue to invest in building the necessary employee and system infrastructure required to support the development of new, and to improve existing, products and services.

Sales and Marketing

The following table presents our sales and marketing expenses, and sales and marketing expenses as a percentage of revenues, for the periods presented (dollars in millions):

	Three Months Ended March 31,	
	2013	2014
	(unaudited)	
Sales and marketing expenses	$1,435	$1,729
Sales and marketing expenses as a percentage of revenues	11.1 %	11.2 %

Sales and marketing expenses consist primarily of compensation and related costs for personnel engaged in customer service, sales, and sales support functions, as well as advertising and promotional expenditures.

Sales and marketing expenses increased $294 million and as a percentage of revenues remained flat from the three months ended March 31, 2013 to the three months ended March 31, 2014. The increase was primarily due to an increase in labor and facilities-related costs of $120 million, largely as a result of a 10% increase in sales and marketing headcount, an increase in advertising and promotional expenses of $103 million, as well as an increase in stock-based compensation expense of $29 million.

We expect that sales and marketing expenses will increase in dollar amount and may increase as a percentage of revenues in the remainder of 2014 and future periods, as we expand our business globally, increase advertising and promotional expenditures in connection with new and existing products, and increase the level of service we provide to our advertisers, Google Network Members, and other partners.

General and Administrative

The following table presents our general and administrative expenses, and general and administrative expenses as a percentage of revenues, for the periods presented (dollars in millions):

	Three Months Ended March 31,	
	2013	2014
	(unaudited)	
General and administrative expenses	$1,015	$1,489
General and administrative expenses as a percentage of revenues	7.8 %	9.6 %

General and administrative expenses consist primarily of compensation and related costs for personnel and facilities, and include costs related to our facilities, finance, human resources, information technology and legal organizations, as well as fees for professional services. Professional services are principally comprised of outside legal, audit, information technology consulting, and outsourcing services. General and administrative expenses also include amortization of certain acquisition-related intangible assets.

General and administrative expenses increased $474 million and also increased as a percentage of revenues from the three months ended March 31, 2013 to the three months ended March 31, 2014. The increase was primarily due to an increase in professional service fees and legal expenses of $226 million during the three months ended March 31, 2014. In addition, the remaining increase was related to an increase in labor and facilities-related costs of $133 million, largely as a result of a 22% increase in general and administrative headcount, an increase in depreciation and equipment-related expense of $36 million, and an increase in stock-based compensation expense of $41 million.

As we expand our business and incur additional expenses, we expect general and administrative expenses will increase in dollar amount and may increase as a percentage of revenues in the remainder of 2014 and in future periods.

Stock-Based Compensation

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We estimate stock-based compensation for Google employees to be approximately $3.2 billion in 2014 and $4.1 billion thereafter. This estimate does not include expenses to be recognized related to employee stock awards that are granted after March 31, 2014 or non-employee stock awards that have been or may be granted. In addition, to the extent forfeiture rates are different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

Interest and Other Income, Net

Interest and other income, net, increased $223 million from the three months ended March 31, 2013 to the three months ended March 31, 2014. This increase was primarily driven by realized gains on non-marketable equity investments of $117 million and previously held equity interest in Nest Labs, Inc. of $103 million.

The costs of our foreign exchange hedging activities that we recognized to interest and other income, net, are primarily a function of the notional amount of the option and forward contracts and their related duration, the movement of the foreign exchange rates relative to the strike prices of the contracts, as well as the volatility of the foreign exchange rates.

As we expand our international business, we believe costs related to hedging activities under our foreign exchange risk management program may increase in dollar amount in the remainder of 2014 and future periods.

Provision for Income Taxes

The following table presents our provision for income taxes and the effective tax rate for the periods presented (dollars in millions):

	Three Months Ended March 31,	
	2013	2014
	(unaudited)	
Provision for income taxes	$354	$822
Effective tax rate	9.1 %	18.4 %

Our provision for income taxes and effective tax rate increased from the three months ended March 31, 2013 to the three months ended March 31, 2014, largely attributed to the expiration of the federal research and development credit as of December 31, 2013.

Our effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected to the extent earnings are lower than anticipated in countries that have lower statutory rates and higher than anticipated in countries that have higher statutory rates. Our effective tax rate could also fluctuate due to the net gains and losses recognized by legal entities on certain hedges and related hedged intercompany and other transactions under our foreign exchange risk management program, by changes in the valuation of our deferred tax assets or liabilities, or by changes in tax laws, regulations, or accounting principles, as well as certain discrete items. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service (IRS) and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

See Critical Accounting Policies and Estimates below for additional information about our provision for income taxes.

Net Loss from Discontinued Operations

Motorola Mobile

On January 29, 2014, we entered into an agreement with Lenovo providing for the disposition of the Motorola Mobile business for a total purchase price of approximately $2.9 billion (subject to certain adjustments), including $1.4 billion to be paid at close, comprised of $660 million in cash and $750 million in Lenovo ordinary shares (subject to a share cap and floor). The remaining $1.5 billion will be paid in the form of an interest-free, three-year prepayable promissory note.

We will maintain ownership of the vast majority of the Motorola Mobile patent portfolio, including current patent applications and invention disclosures, which will be licensed back to Motorola Mobile for its continued operations. Additionally, in connection with the sale, we will indemnify Lenovo for certain potential liabilities of the Motorola Mobile

business. The transaction is subject to the satisfaction of regulatory requirements, customary closing conditions and any other needed approvals and is expected to close in 2014.

As such, financial results of Motorola Mobile are presented as net loss from discontinued operations on the Consolidated Statements of Income for the three months ended March 31, 2013 and 2014; and assets and liabilities of Motorola Mobile to be disposed of are presented as assets held for sale and liabilities held for sale on the Consolidated Balance Sheet as of March 31, 2014, respectively.

The following table presents financial results of the Motorola Mobile business included in net loss from discontinued operations for the three months ended March 31, 2013 and 2014 (in millions, unaudited):

	Three Months Ended March 31,	
	2013	2014
Revenues	$1,018	$1,377
Loss from discontinued operations before income taxes	(271)	(274)
Benefits from income taxes	67	76
Net loss from discontinued operations	$(204)	$(198)

Motorola Home

In December 2012, we entered into an agreement with Arris Group, Inc. (Arris) and certain other persons providing for the disposition of the Motorola Home business. The transaction closed on April 17, 2013. As such, financial results of Motorola Home were included in net loss from discontinued operations for the three months ended March 31, 2013.

The following table presents financial results of the Motorola Home business included in net loss from discontinued operations for the three months ended March 31, 2013 (in millions, unaudited):

	Three Months Ended March 31, 2013
Revenues	$738
Income from discontinued operations before income taxes	47
Provision for income taxes	(25)
Net income from discontinued operations	$22

Liquidity and Capital Resources

As of March 31, 2014, we had $59.5 billion of cash, cash equivalents, and marketable securities after including $160 million of cash and cash equivalents classified as assets held for sale. Cash equivalents and marketable securities are comprised of time deposits, money market and other funds, including cash collateral received related to our securities lending program, highly liquid debt instruments of the U.S. government and its agencies, debt instruments issued by foreign governments, debt instruments issued by municipalities in the U.S., corporate securities, mortgage-backed securities, asset-backed securities and marketable equity securities.

As of March 31, 2014, $34.5 billion of the $59.5 billion of cash, cash equivalents, and marketable securities was held by our foreign subsidiaries. If these funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

Our principal sources of liquidity are our cash, cash equivalents, and marketable securities, as well as the cash flow that we generate from our operations. As of March 31, 2014, we had unused letters of credit of approximately $490 million. We believe that our sources of funding will be sufficient to satisfy our currently anticipated cash requirements through at least the next 12 months. Our liquidity could be negatively affected by a decrease in demand for our products and services. In addition, we may make acquisitions or license products and technologies complementary to our business and may need to raise additional capital through future debt or equity financing to provide for greater flexibility to fund any such acquisitions and licensing activities. Additional financing may not be available at all or on terms favorable to us.

We have a debt financing program of up to $3.0 billion through the issuance of commercial paper. Net proceeds from this program are used for general corporate purposes. As of March 31, 2014, we had $2.0 billion of commercial paper outstanding recorded as short-term debt, with a weighted-average interest rate of 0.1% that mature at various dates through August 2014. Average commercial paper borrowings during the quarter were $2.2 billion and the maximum amount outstanding during the quarter was $2.4 billion. In conjunction with this program, we have a $3.0 billion revolving credit facility expiring in July 2016. The interest rate for the credit facility is determined based on a formula using certain market rates. As of March 31, 2014, we were in compliance with the financial covenant in the credit facility and no amounts were outstanding.

In February 2014, we issued $1.0 billion of unsecured senior notes (2014 Notes) due in 2024. In May 2011, we issued $3.0 billion of unsecured senior notes (2011 Notes) in three equal tranches, due in 2014, 2016, and 2021. The net proceeds from the sale of the 2011 Notes were used to repay a portion of our outstanding commercial paper and for general corporate purposes. We intend to use the net proceeds from the issuance of the 2014 Notes for general corporate purposes including the repayment of the principal amount of our 2011 Notes due on May 19, 2014.

As of March 31, 2014, the total carrying value and estimated fair value of the 2011 and 2014 notes were $4.0 billion and $4.1 billion, respectively. The fair value was determined based on observable market prices of identical instruments in less active markets. We are not subject to any financial covenants under the notes.

In August 2013, we entered into a $258 million capital lease obligation on certain property expiring in 2028 with an option to purchase in 2016. The effective rate of the capital lease obligation approximates the market rate. The estimated fair value of the capital lease obligation approximated its carrying value as of March 31, 2014.

In summary, our cash flows were as follows (in millions):

	Three Months Ended March 31,	
	2013	2014
	(unaudited)	
Net cash provided by operating activities	$3,633	$4,391
Net cash used in investing activities	(2,441)	(7,307)
Net cash (used in) provided by financing activities	(517)	822

Cash Provided by Operating Activities

Our largest source of cash provided by operating cash flows is advertising revenues generated by Google websites and Google Network Members' websites. We also generate cash from the sale of our hardware products, primarily in the Motorola Mobile business. Our primary uses of cash from operating activities include payments to our Google Network Members and distribution partners, which are based on the revenue share or fixed fee arrangements, as well as payments for manufacturing and inventory-related costs primarily for the Motorola Mobile business. In addition, uses of cash from operating activities include compensation and related costs, other general corporate expenditures and income taxes.

Cash provided by operating activities consist of net income adjusted for certain non-cash items, including stock-based compensation expense, depreciation, amortization, deferred income taxes, excess tax benefits from stock-based award activities, as well as the effect of changes in working capital and other activities.

Net cash provided by operating activities increased from the three months ended March 31, 2013 to the three months ended March 31, 2014, primarily due to increased net income adjusted for depreciation and loss on disposal of property and equipment and stock-based compensation expense offset by gains on equity interest and sale of non-marketable securities. In addition, there was a net increase in cash from changes in working capital primarily as a result of an increase in income taxes and a decrease in inventories, offset by an increase in prepaid and other assets.

As we expand our business internationally, we have offered payment terms to certain advertisers that are standard in their locales but longer than terms we would generally offer to our domestic advertisers. This may increase our working capital requirements and may have a negative effect on cash provided by our operating activities.

Cash Used In Investing Activities

Cash provided by or used in investing activities primarily consist of purchases, maturities, and sales of marketable securities, acquisitions of businesses and intangible assets, divestiture of businesses, and purchases of property and equipment. In addition, cash provided by or used in investing activities include our investments in reverse repurchase agreements and the cash collateral received or returned from our securities lending program.

Cash used in investing activities increased from the three months ended March 31, 2013 to the three months ended March 31, 2014, primarily attributable to an increase in spend related to acquisitions and a net increase in purchases of marketable securities. In addition, there was an increase in capital expenditures from the three months ended March 31, 2013 to the three months ended March 31, 2014 primarily related to our production equipment, data centers, and real estate purchases.

In order to manage expected increases in internet traffic, advertising transactions, and new products and services, and to support our overall global business expansion, we expect to make significant investments in production equipment, our systems, data centers, corporate facilities, and information technology infrastructure in 2014 and thereafter. However, the amount of our capital expenditures has fluctuated and may continue to fluctuate on a quarterly basis.

In addition, we expect to continue to spend cash on acquisitions and other investments. These acquisitions generally enhance the breadth and depth of our expertise in engineering and other functional areas, our technologies, and our product and service offerings.

Cash Provided by (Used In) Financing Activities

Cash provided by or used in financing activities consists primarily of net proceeds or payments from issuance or repayments of debt and net proceeds or payments and excess tax benefits from stock-based award activities.

Cash provided by financing activities increased from the three months ended March 31, 2013 to the three months ended March 31, 2014, primarily driven by an increase in net cash proceeds related to debt as we issued our $1.0 billion of unsecured senior notes in February 2014, offset by an increase in net payments for stock-based award activities.

Contractual Obligations

We had long-term taxes payable of $2.8 billion as of March 31, 2014 primarily related to tax positions for which the timing of the ultimate resolution is uncertain. At this time, we are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

Critical Accounting Policies and Estimates

We prepare our consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles (GAAP). In doing so, we have to make estimates and assumptions that affect our reported amounts of assets, liabilities, revenues, and expenses, as well as related disclosure of contingent assets and liabilities. In some cases, we could reasonably have used different accounting policies and estimates. In some cases, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis. We refer to accounting estimates of this type as critical accounting policies and estimates, which we discuss further below. We have reviewed our critical accounting policies and estimates with the audit committee of our board of directors.

Income Taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes.

Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest and penalties.

Our effective tax rates have differed from the statutory rate primarily due to the tax impact of foreign operations, state taxes, certain benefits realized related to stock-based award activities, and research and development tax credits. The effective tax rates were 9.1% and 18.4% for the three months ended March 31, 2013 and 2014, respectively. Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries that have lower statutory rates and higher than anticipated in countries that have higher statutory rates, the net gains and losses recognized by legal entities on certain hedges and related hedged intercompany and other transactions under our foreign exchange risk management program, changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws, regulations, or accounting principles, as well as certain discrete items. In addition, we are subject to the continuous examination of our income tax returns by the IRS and other tax authorities which may assert assessments against us. We regularly assess the likelihood of adverse outcomes resulting from these examinations and assessments to determine the adequacy of our provision for income taxes.
Loss Contingencies
We are regularly subject to claims, suits, government investigations, and other proceedings involving competition and antitrust, intellectual property, privacy, indirect taxes, labor and employment, commercial disputes, content generated by our users, goods and services offered by advertisers or publishers using our platforms, and other matters. Certain of these matters include speculative claims for substantial or indeterminate amounts of damages. We record a liability when we believe that it is both probable that a loss has been incurred, and the amount can be reasonably estimated. If we determine that a loss is possible and a range of the loss can be reasonably estimated, we disclose the range of the possible loss in the Notes to the Consolidated Financial Statements. We evaluate, on a monthly basis, developments in our legal matters that could affect the amount of liability that has been previously accrued, and the

matters and related ranges of possible losses disclosed, and make adjustments and changes to our disclosures as appropriate. Significant judgment is required to determine both likelihood of there being and the estimated amount of a loss related to such matters. Until the final resolution of such matters, there may be an exposure to loss in excess of the amount recorded, and such amounts could be material. Should any of our estimates and assumptions change or prove to have been incorrect, it could have a material impact on our business, consolidated financial position, results of operations, or cash flows. See Note 11 of Notes to Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional information regarding contingencies.

Business Combinations

We allocate the fair value of purchase consideration to the tangible assets acquired, liabilities assumed and intangible assets acquired based on their estimated fair values. The excess of the fair value of purchase consideration over the fair values of these identifiable assets and liabilities is recorded as goodwill. When determining the fair values of assets acquired and liabilities assumed, management makes significant estimates and assumptions, especially with respect to intangible assets. Critical estimates in valuing certain intangible assets include but are not limited to future expected cash flows from customer relationships and acquired patents and developed technology; and discount rates. Management’s estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. Other estimates associated with the accounting for acquisitions may change as additional information becomes available regarding the assets acquired and liabilities assumed, as more fully discussed in Note 6 of Notes to Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Goodwill

Goodwill is allocated to reporting units expected to benefit from the business combination. We test goodwill for impairment at the reporting unit level at least annually, or more frequently if events or changes in circumstances occur that would more likely than not reduce the fair value of a reporting unit below its carrying value. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach. Goodwill impairment tests require judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. As of March 31, 2014, no impairment of goodwill has been identified.

Impairment of Marketable and Non-Marketable Securities

We periodically review our marketable and non-marketable securities for impairment. If we conclude that any of these investments are impaired, we determine whether such impairment is other-than-temporary. Factors we consider to make such determination include the duration and severity of the impairment, the reason for the decline in value and the potential recovery period and our intent to sell. For marketable debt securities, we also consider whether (1) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis, and (2) the amortized cost basis cannot be recovered as a result of credit losses. If any impairment is considered other-than-temporary, we will write down the asset to its fair value and record the corresponding charge as interest and other income, net.

Available Information

Our website is located at www.google.com, and our investor relations website is located at http://investor.google.com. The following filings are available through our investor relations website after we file them with the SEC: Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and our Proxy Statements for our annual meetings of stockholders, for the last three years, and are also available for download free of charge. We also provide a link to the section of the SEC's website at www.sec.gov that has all of our public filings, including Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, all amendments to those reports, our Proxy Statements, and other ownership related filings. Further, a copy of this Quarterly Report on Form 10-Q is located at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330.

We webcast our earnings calls and certain events we participate in or host with members of the investment community on our investor relations website. Additionally, we provide notifications of news or announcements regarding our financial performance, including SEC filings, investor events, press and earnings releases, and blogs as part of our investor relations website as well as on our investor relations Google+ page (https://plus.google.com/

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+GoogleInvestorRelations/posts). Investors and others can receive notifications of new information posted on our investor relations website in real time by signing up for email alerts and RSS feeds. Further corporate governance information, including our certificate of incorporation, bylaws, governance guidelines, board committee charters, and code of conduct, is also available on our investor relations website under the heading “Corporate Governance.” The content of our websites are not incorporated by reference into this Quarterly Report on Form 10-Q or in any other report or document we file with the SEC, and any references to our websites are intended to be inactive textual references only.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
We are exposed to financial market risks, including changes in currency exchange rates and interest rates.
Foreign Currency Exchange Risk

We transact business globally in multiple currencies. Our international revenues, as well as costs and expenses denominated in foreign currencies, expose us to the risk of fluctuations in foreign currency exchange rates against the US dollar. Our most significant currency exposures are the Euro, the British pound, and Japanese Yen. We are a net receiver of foreign currencies and therefore benefit from a weakening of the U.S. dollar and are adversely affected by a strengthening of the U.S. dollar relative to the foreign currency.

We use foreign exchange option contracts to protect our forecasted U.S. dollar-equivalent earnings from adverse changes in foreign currency exchange rates. These hedging contracts reduce, but do not entirely eliminate the impact of adverse currency exchange rate movements. We designate these option contracts as cash flow hedges for accounting purposes. The fair value of the option contract is separated into its intrinsic and time values. Changes in the time value are recorded in interest and other income, net. Changes in the intrinsic value are recorded as a component of accumulated other comprehensive income (AOCI) and subsequently reclassified into revenues to offset the hedged exposures as they occur.

We considered the historical trends in currency exchange rates and determined that it was reasonably possible that changes in exchange rates of 20% for our foreign currency options could be experienced in the near term. If the U.S. dollar weakened by 20%, the amount recorded in AOCI before tax effect would have been approximately $9 million lower at March 31, 2014, and the total amount of expense recorded as interest and other income, net, would have been approximately $62 million higher at March 31, 2014. If the U.S. dollar strengthened by 20%, the amount recorded in accumulated AOCI before tax effect would have been approximately $1.3 billion higher at March 31, 2014, and the total amount of expense recorded as interest and other income, net, would have been approximately $58 million higher at March 31, 2014. The impact in AOCI would offset our hedged exposures as they occur.

In addition, we use foreign exchange forward contracts to offset the foreign exchange risk on our assets and liabilities denominated in currencies other than the local currency of the subsidiary. These forward contracts reduce, but do not entirely eliminate the impact of currency exchange rate movements on our assets and liabilities. The foreign currency gains and losses on the assets and liabilities are recorded in interest and other income, net, which are offset by the gains and losses on the forward contracts.

We considered the historical trends in currency exchange rates and determined that it was reasonably possible that adverse changes in exchange rates of 20% for all currencies could be experienced in the near term. These changes would have resulted in an adverse impact on income before income taxes of approximately $88 million at March 31, 2014. The adverse impact at March 31, 2014 is after consideration of the offsetting effect of approximately $714 million from foreign exchange contracts in place for the month of March 31, 2014. These reasonably possible adverse changes in exchange rates of 20% were applied to total monetary assets and liabilities denominated in currencies other than the local currencies at the balance sheet dates to compute the adverse impact these changes would have had on our income before income taxes in the near term.

Interest Rate Risk

Our investment strategy is to achieve a return that will allow us to preserve capital and maintain liquidity requirements. We invest primarily in U.S. government and its agency securities, money market and other funds, corporate debt securities, mortgage-backed securities, debt instruments issued by foreign governments, municipal securities, time deposits, and asset backed securities. By policy, we limit the amount of credit exposure to any one issuer. Our investments in both fixed rate and floating rate interest earning securities carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. As of March 31, 2014, unrealized losses on our marketable debt securities were primarily due to temporary interest rate fluctuations as a result of higher market interest rates compared to the fixed interest rates on our debt securities. We account for both fixed and variable rate securities at fair value with changes on gains and losses recorded in AOCI until the securities are sold. We use interest rate derivative contracts to hedge realized gains and losses on our securities. These derivative contracts are accounted for at fair value with changes in fair value recorded in Interest and other income, net.

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We considered the historical volatility of interest rates and determined that it was reasonably possible that an adverse change of 100 basis points could be experienced in the near term. A hypothetical 1.00% (100 basis points) increase in interest rates would have resulted in a decrease in the fair values of our marketable securities and interest rate derivative contracts of approximately $1.0 billion at March 31, 2014.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of March 31, 2014, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls and Procedures

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For a description of our material pending legal proceedings, please refer to Note 11 “Contingencies - Legal Matters” of the Notes to Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q, which is incorporated herein by reference.

ITEM 1A. RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties, including those described below, which could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common and capital stock.

Risks Related to Our Business and Industry

We face intense competition. If we do not continue to innovate and provide products and services that are useful to users, we may not remain competitive, and our revenues and operating results could be adversely affected.

Our business is rapidly evolving and intensely competitive, and is subject to changing technologies, shifting user needs, and frequent introductions of new products and services. Our ability to compete successfully depends heavily on providing products and services that make using the internet a more useful and enjoyable experience for our users and delivering innovative products and technologies to the marketplace. As our business has evolved, the competitive pressure to innovate will now encompass a wider range of products and services, including products and services that may be outside of our historical core business.

We have many competitors in different industries, including general purpose search engines, vertical search engines and e-commerce sites, social networking sites, traditional media companies, wireless mobile device companies, and providers of online products and services. Our current and potential competitors range from large and established companies to emerging start-ups. Established companies have longer operating histories and more established relationships with customers and users, and they can use their experience and resources in ways that could affect our competitive position, including by making acquisitions, investing aggressively in research and development, aggressively initiating intellectual property claims (whether or not meritorious) and competing aggressively for advertisers and websites. Emerging start-ups may be able to innovate and provide products and services faster than we can.

Our competitors are constantly developing innovations in web search, online advertising, wireless mobile devices, and web-based products and services. The research and development of new, technologically advanced products is also a complex and uncertain process requiring high levels of innovation and investment, as well as the accurate anticipation of technology, market trends and consumer needs. As a result, we must continue to invest significant resources in research and development, including through acquisitions, in order to enhance our web search technology and our existing products and services, and introduce new products and services that people can easily and effectively use. If we are unable to provide quality products and services, then acceptance rates for our products and services could decline and affect consumer and advertiser perceptions of our brand. In addition, these new products and services may present new and difficult technological and legal challenges, and we may be subject to claims if users of these offerings experience service disruptions or failures or other issues. Our operating results would also suffer if our innovations are not responsive to the needs of our users, advertisers, and Google Network Members, are not appropriately timed with market opportunities, or are not effectively brought to market. As technology continues to develop, our competitors may be able to offer user experiences that are, or that are seen to be, substantially similar to or better than ours. This may force us to compete in different ways and expend significant resources in order to remain competitive. If our competitors are more successful than we are in developing compelling products or in attracting and retaining users, advertisers, and content providers, our revenues and operating results could be adversely affected.

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Our ongoing investment in new businesses and new products, services, and technologies is inherently risky, and could disrupt our ongoing businesses.

We have invested and expect to continue to invest in new businesses, products, services, and technologies. Such endeavors may involve significant risks and uncertainties, including distraction of management from current operations, insufficient revenues to offset liabilities assumed and expenses associated with these new investments, inadequate return of capital on our investments, and unidentified issues not discovered in our due diligence of such strategies and offerings. Because these new ventures are inherently risky, no assurance can be given that such strategies and offerings will be successful and will not adversely affect our reputation, financial condition, and operating results.

More people are using devices other than desktop computers to access the internet and accessing new devices to make search queries. If manufacturers and users do not widely adopt versions of our web search technology, products, or operating systems developed for these devices, our business could be adversely affected.

The number of people who access the internet through devices other than desktop computers, including mobile phones, smartphones, handheld computers such as netbooks and tablets, video game consoles, and television set-top devices, is increasing dramatically. The lower resolution, functionality, and memory associated with some alternative devices make the use of our products and services through such devices more difficult and the versions of our products and services developed for these devices may not be compelling to users, manufacturers, or distributors of alternative devices. Each manufacturer or distributor may establish unique technical standards for its devices, and our products and services may not work or be viewable on these devices as a result. Some manufacturers may also elect not to include our products on their devices. In addition, search queries are increasingly being undertaken via “apps” tailored to particular devices or social media platforms, which could affect our share of the search market over time. As new devices and platforms are continually being released, it is difficult to predict the problems we may encounter in adapting our products and services and developing competitive new products and services. We expect to continue to devote significant resources to the creation, support, and maintenance of products and services across multiple platforms and devices. If we are unable to attract and retain a substantial number of alternative device manufacturers, distributors, and users to our products and services, or if we are slow to develop products and technologies that are more compatible with alternative devices and platforms, we will fail to capture the opportunities available as consumers and advertisers transition to a dynamic, multi-screen environment.

We generate a significant portion of our revenues from advertising, and a reduction in spending by or loss of advertisers could seriously harm our business.

We generated 91% of Google revenues from our advertisers in 2013 and 90% in the three months ended March 31, 2014. Our advertisers can generally terminate their contracts with us at any time. Advertisers will not continue to do business with us if their investment in advertising with us does not generate sales leads, and ultimately customers, or if we do not deliver their advertisements in an appropriate and effective manner. If we are unable to remain competitive and provide value to our advertisers, they may stop placing ads with us, which would adversely affect our revenues and business.

In addition, expenditures by advertisers tend to be cyclical, reflecting overall economic conditions and budgeting and buying patterns. Adverse macroeconomic conditions can also have a material negative impact on the demand for advertising and cause our advertisers to reduce the amounts they spend on advertising, which could adversely affect our revenues and business.

Our revenue growth rate could decline over time, and we anticipate downward pressure on our operating margin in the future.

Our revenue growth rate could decline over time as a result of a number of factors, including as a result of:

- increasing competition,
- changes in property mix, platform mix and geographical mix,
- the challenges in maintaining our growth rate as our revenues increase to higher levels,
- the evolution of the online advertising market, including the increasing variety of online platforms for advertising, and the other markets in which we participate, and
- the success of our investments in new businesses, products, services, and technologies.

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The revenue growth rate of our Motorola Mobile business will also depend on a number of factors, including the success of our new products, our reliance on several large customers, the absence of long-term exclusivity arrangements with such customers, our ability to gain significant market share in the mobile devices space, our reliance on third-party distributors, representatives and retailers to sell certain of our products and the successful implementation of our product and operating system strategies. Furthermore, consolidation in the telecommunications industry could negatively impact our business because there would be fewer network operators and it could be more difficult to replace any lost customers. Any of these factors could have a negative impact on our Motorola Mobile business and have an adverse effect on our consolidated financial results.

We believe our operating margin will experience downward pressure as a result of increasing competition and increased expenditures for many aspects of our business, including Motorola, and new lines of business. For instance, our operating margin will experience downward pressure if a greater percentage of our revenues comes from ads placed on our Google Network Members' websites compared to revenues generated through ads placed on our own websites or if we spend a proportionately larger amount to promote the distribution of certain products, including Google Chrome. Both the margin on revenues we generate from our Google Network Members and the margin on revenues from our Motorola business are significantly less than the margin on revenues we generate from advertising on our websites. Also, the margin on the sale of digital content and apps, advertising revenues from mobile devices and newer advertising formats are generally less than the margin on revenues we generate from advertising on our websites. Additionally, the margin we earn on revenues generated from our Google Network Members could decrease in the future if we pay an even larger percentage of advertising fees to our Google Network Members.

We are subject to increased regulatory scrutiny that may negatively impact our business.

The growth of our company and our expansion into a variety of new fields implicate a variety of new regulatory issues, and we have experienced increased regulatory scrutiny as we have grown. We continue to cooperate with the European Commission (EC), other international regulatory authorities, and several state attorneys general in investigations they are conducting with respect to our business and its impact on competition. Legislators and regulators, including those conducting investigations in the U.S. and Europe, may make legal and regulatory changes, or interpret and apply existing laws, in ways that make our products and services less useful to our users, require us to incur substantial costs, expose us to unanticipated civil or criminal liability, or cause us to change our business practices. These changes or increased costs could negatively impact our business and results of operations in material ways.

We are regularly subject to claims, suits, government investigations, and other proceedings that may result in adverse outcomes.

We are regularly subject to claims, suits, government investigations, and other proceedings involving competition and antitrust (such as the pending investigations by the EC), intellectual property, privacy, consumer protection, tax, labor and employment, commercial disputes, content generated by our users, goods and services offered by advertisers or publishers using our platforms, and other matters. The sale of hardware products also exposes us to the risk of product liability and other litigation involving assertions about product defects, as well as health and safety, hazardous materials usage, and other environmental concerns. In addition, our businesses face intellectual property litigation, as further discussed later, that exposes us to the risk of exclusion and cease and desist orders, which could limit our ability to sell products and services.

Such claims, suits, government investigations, and proceedings are inherently uncertain and their results cannot be predicted with certainty. Regardless of the outcome, such legal proceedings can have an adverse impact on us because of legal costs, diversion of management resources, and other factors. Determining reserves for our pending litigation is a complex, fact-intensive process that requires significant judgment. It is possible that a resolution of one or more such proceedings could result in substantial fines and penalties that could adversely affect our business, consolidated financial position, results of operations, or cash flows in a particular period. These proceedings could also result in reputational harm, criminal sanctions, consent decrees, or orders preventing us from offering certain features, functionalities, products, or services, requiring a change in our business practices or product recalls or other field action, or requiring development of non-infringing or otherwise altered products or technologies. Any of these consequences could adversely affect our business and results of operations.

Acquisitions and investments could result in operating difficulties, dilution, and other harmful consequences that may adversely impact our business and results of operations.

Acquisitions are an important element of our overall corporate strategy and use of capital, and these transactions could be material to our financial condition and results of operations. We expect to continue to evaluate and enter into discussions regarding a wide array of potential strategic transactions. The process of integrating an acquired company, business, or technology has created, and will continue to create, unforeseen operating difficulties and expenditures. The areas where we face risks include:

- Diversion of management time and focus from operating our business to acquisition integration challenges.
- Failure to successfully further develop the acquired business or technology.
- Implementation or remediation of controls, procedures, and policies at the acquired company.
- Integration of the acquired company's accounting, human resource, and other administrative systems, and coordination of product, engineering, and sales and marketing functions.
- Transition of operations, users, and customers onto our existing platforms.
- Failure to obtain required approvals on a timely basis, if at all, from governmental authorities, or conditions placed upon approval, under competition and antitrust laws which could, among other things, delay or prevent us from completing a transaction, or otherwise restrict our ability to realize the expected financial or strategic goals of an acquisition.
- In the case of foreign acquisitions, the need to integrate operations across different cultures and languages and to address the particular economic, currency, political, and regulatory risks associated with specific countries.
- Cultural challenges associated with integrating employees from the acquired company into our organization, and retention of employees from the businesses we acquire.
- Liability for activities of the acquired company before the acquisition, including patent and trademark infringement claims, violations of laws, commercial disputes, tax liabilities, and other known and unknown liabilities.
- Litigation or other claims in connection with the acquired company, including claims from terminated employees, customers, former stockholders, or other third parties.

Our failure to address these risks or other problems encountered in connection with our past or future acquisitions and investments could cause us to fail to realize the anticipated benefits of such acquisitions or investments, incur unanticipated liabilities, and harm our business generally.
Our acquisitions could also result in dilutive issuances of our equity securities, the incurrence of debt, contingent liabilities, or amortization expenses, or impairment of goodwill and purchased long-lived assets, and restructuring charges, any of which could harm our financial condition or results. Also, the anticipated benefit of many of our acquisitions may not materialize.

Our business depends on a strong brand, and failing to maintain and enhance our brand would hurt our ability to expand our base of users, advertisers, Google Network Members, and other partners.

The brand identity that we have developed has significantly contributed to the success of our business. Maintaining and enhancing the “Google” brand is critical to expanding our base of users, advertisers, Google Network Members, and other partners. We believe that the importance of brand recognition will increase due to the relatively low barriers to entry in the internet market. Our brand may be negatively impacted by a number of factors, including data protection and security issues, service outages, and product malfunctions. If we fail to maintain and enhance the “Google” brand, or if we incur excessive expenses in this effort, our business, operating results, and financial condition will be materially and adversely affected. Maintaining and enhancing our brand will depend largely on our ability to be a technology leader and continue to provide high-quality innovative products and services, which we may not do successfully.

A variety of new and existing U.S. and foreign laws could subject us to claims or otherwise harm our business.

We are subject to numerous U.S. and foreign laws and regulations covering a wide variety of subject matters. New laws and regulations (or new interpretations of existing laws and regulations) may also impact our business. The costs of compliance with these laws and regulations are high and are likely to increase in the future. Any failure on our part to comply with these laws and regulations can result in negative publicity and diversion of management time and effort and may subject us to significant liabilities and other penalties.

Furthermore, many of these laws were adopted prior to the advent of the internet and related technologies and, as a result, do not contemplate or address the unique issues of the internet and related technologies. The laws that do reference the internet are being interpreted by the courts, but their applicability and scope remain uncertain. For example, the laws relating to the liability of providers of online services are currently unsettled both within the U.S. and abroad. Claims have also been, or may be, threatened and filed against us under both U.S. and foreign laws for defamation, invasion of privacy and other tort claims, unlawful activity, patent, copyright and trademark infringement, or other theories based on the nature and content of the materials searched and the ads posted by our users, our products and services, or content generated by our users. Moreover, current and new patent laws such as U.S. patent laws and European patent laws may affect the ability of companies, including us, to protect their innovations and defend against claims of patent infringement.

In addition, the Digital Millennium Copyright Act has provisions that limit, but do not necessarily eliminate, our liability for caching or hosting, or for listing or linking to, third-party websites that include materials that infringe copyrights or other rights, so long as we comply with the statutory requirements of this act. Any future legislation impacting these safe harbors may adversely impact us. Various U.S. and international laws restrict the distribution of materials considered harmful to children and impose additional restrictions on the ability of online services to collect information from minors. In the area of data protection, many states have passed laws requiring notification to users when there is a security breach for personal data, such as California's Information Practices Act. We face similar risks and costs as our products and services are offered in international markets and may be subject to additional regulations.

We are, and may in the future be, subject to intellectual property or other claims, which are costly to defend, could result in significant damage awards, and could limit our ability to use certain technologies in the future.

Internet, technology, media, and other companies own large numbers of patents, copyrights, trademarks, and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. In addition, patent holding companies may continue to seek to monetize patents they have purchased or otherwise obtained. As we have grown, the intellectual property rights claims against us have increased and may continue to increase as we develop new products, services, and technologies.

We have had patent, copyright, and trademark infringement lawsuits filed against us claiming that certain of our products, services, and technologies, including Android, Google Search, Google AdWords, Google AdSense, Motorola products, Google Maps, Google Books, Google News, Google Image Search, Google Chrome, Google Talk, Google Voice, and YouTube, among others, infringe the intellectual property rights of others. Third parties have also sought broad injunctive relief against us by filing claims in U.S. and international courts and the U.S. International Trade Commission (ITC) for exclusion and cease and desist orders, which could limit our ability to sell our products or services in the U.S. or elsewhere if our products or services or those of our customers or suppliers are found to infringe the intellectual property subject to the claims. Adverse results in any of these lawsuits may include awards of substantial monetary damages, costly royalty or licensing agreements (if licenses are available at all), or orders preventing us from offering certain features, functionalities, products, or services, and may also cause us to change our business practices, and require development of non-infringing products or technologies, which could result in a loss of revenues for us and otherwise harm our business.

In addition, many of our agreements with our customers and partners, including certain suppliers, require us to indemnify them for certain intellectual property infringement claims against them, which could increase our costs as a result of defending such claims, and may require that we pay significant damages if there were an adverse ruling in any such claims. Such customers and partners may also discontinue the use of our products, services, and technologies, as a result of injunctions or otherwise, which could result in loss of revenues and adversely impact our business. Moreover, supplier provided intellectual property indemnities to us, when obtainable, may not cover all damages and losses suffered by us and our customers from covered products.

Regardless of the merits of the claims, intellectual property claims are often time consuming, expensive to litigate or settle, and cause significant diversion of management attention. To the extent such intellectual property infringement claims are successful, they may have an adverse effect on our business, consolidated financial position, results of operations, or cash flows.

Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products, services, and brand.

Our patents, trademarks, trade secrets, copyrights, and other intellectual property rights are important assets for us. Various events outside of our control pose a threat to our intellectual property rights, as well as to our products, services and technologies. For example, effective intellectual property protection may not be available in every country in which our products and services are distributed or made available through the internet. Also, the efforts we have taken to protect our proprietary rights may not be sufficient or effective.

Although we seek to obtain patent protection for our innovations, it is possible we may not be able to protect some of these innovations. Moreover, because of our long-term interests in open source, we may not have adequate patent protection for certain innovations that later turn out to be important. Furthermore, there is always the possibility, despite our efforts, that the scope of the protection gained will be insufficient or that an issued patent may be deemed invalid or unenforceable.

We also seek to maintain certain intellectual property as trade secrets. The secrecy could be compromised by outside parties, or by our employees, which could cause us to lose the competitive advantage resulting from these trade secrets.

We also face risks associated with our trademarks. For example, there is a risk that the word “Google” could become so commonly used that it becomes synonymous with the word “search.” If this happens, we could lose protection for this trademark, which could result in other people using the word “Google” to refer to their own products, thus diminishing our brand.

Any significant impairment of our intellectual property rights could harm our business and our ability to compete. Also, protecting our intellectual property rights is costly and time consuming. Any increase in the unauthorized use of our intellectual property could make it more expensive to do business and harm our operating results.

We may be subject to legal liability associated with providing online services or content.

We host and provide a wide variety of services and products that enable users to exchange information, advertise products and services, conduct business, and engage in various online activities both domestically and internationally. The law relating to the liability of providers of these online services and products for activities of their users is still somewhat unsettled both within the U.S. and internationally. Claims have been threatened and have been brought against us for defamation, negligence, breaches of contract, copyright or trademark infringement, unfair competition, unlawful activity, tort, including personal injury, fraud, or other theories based on the nature and content of information that we publish or to which we provide links or that may be posted online or generated by us or by third parties, including our users. In addition, we are and have been and may again in the future be subject to domestic or international actions alleging that certain content we have generated or third-party content that we have made available within our services violates U.S. and non-U.S. law.

We also arrange for the distribution of third-party advertisements to third-party publishers and advertising networks, and we offer third-party products, services, or content. We may be subject to claims concerning these products, services, or content by virtue of our involvement in marketing, branding, broadcasting, or providing access to them, even if we do not ourselves host, operate, provide, or provide access to these products, services, or content. Defense of any such actions could be costly and involve significant time and attention of our management and other resources, may result in monetary liabilities or penalties, and may require us to change our business in an adverse manner.

Privacy concerns relating to our technology could damage our reputation and deter current and potential users from using our products and services.

From time to time, concerns have been expressed about whether our products, services, or processes compromise the privacy of users and others. Concerns about our practices with regard to the collection, use, disclosure, or security of personal information or other privacy related matters, even if unfounded, could damage our reputation and adversely affect our operating results.

In addition, as nearly all of our products and services are web-based, the amount of data we store for our users on our servers (including personal information) has been increasing. Any systems failure or compromise of our security that results in the release of our users' data could seriously limit the adoption of our products and services, as well as harm our reputation and brand and, therefore, our business. We expect to continue to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand the number of web-based products and services we offer, and operate in more countries.

Regulatory authorities around the world are considering a number of legislative and regulatory proposals concerning data protection. In addition, the interpretation and application of consumer and data protection laws in the U.S., Europe and elsewhere are often uncertain and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could have an adverse effect on our business and results of operations. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

We face a number of manufacturing and supply chain risks that, if not properly managed, could adversely impact our financial results and prospects.

We face a number of risks related to manufacturing and supply chain management. For instance, the products we sell may have quality issues resulting from the design or manufacture of the product, or from the software used in the product. Sometimes, these issues may be caused by components we purchase from other manufacturers or suppliers. If the quality of our products does not meet our customers' expectations or our products are found to be defective, then our sales and operating earnings, and ultimately our reputation, could be negatively impacted.

We rely on third parties to manufacture many of our assemblies and finished products, and we have third-party arrangements for the design of some components and parts. Our business could be negatively affected if we are not able to engage third parties with the necessary capabilities or capacity on reasonable terms, or if those we engage fail to meet their obligations (whether due to financial difficulties or other reasons), or make adverse changes in the pricing or other material terms of our arrangements with them.

In the past, Motorola, like many electronics manufacturers, has experienced supply shortages and price increases driven by raw material availability, manufacturing capacity, labor shortages, industry allocations, natural disasters and significant changes in the financial or business condition of its suppliers. Workaround plans to address shortages have entailed in the past, and could entail in the future, increased freight costs for expedited shipments. There is no assurance that we will not experience shortages or other supply chain disruptions in the future or that they will not negatively impact our operations. In addition, some of the components we use in our products are available only from a single source or limited sources, and there is no assurance that we would be able to find replacement vendors on favorable terms or at all in the event of a supply chain disruption.

Additionally, because many of our supply contracts have volume-based pricing or minimum purchase requirements, if the volume of our hardware sales decreases or does not reach projected targets, we could face increased materials and manufacturing costs or other financial liabilities that could make our hardware products more costly per unit to manufacture and therefore less competitive and negatively impact our financial results. Further, certain of our competitors may negotiate more favorable contractual terms based on volume and other commitments that may provide them with competitive advantages and may impact our supply.

We also require our suppliers and business partners to comply with law and company policies regarding workplace and employment practices, environmental compliance and intellectual property licensing, but we do not control them or their practices. If any of them violates laws or implements practices regarded as unethical, we could experience supply chain disruptions, canceled orders, terminations of or damage to key relationships, and damage to our reputation. If any of them fails to procure necessary license rights to third-party intellectual property, legal action could ensue that could impact the salability of our products and expose us to financial obligations to third parties.

The Dodd-Frank Wall Street Reform and Consumer Protection Act includes disclosure requirements regarding the use of certain minerals mined from the Democratic Republic of Congo and adjoining countries (DRC) and procedures pertaining to a manufacturer's efforts regarding the source of such minerals. SEC rules implementing these requirements may have the effect of reducing the pool of suppliers who can supply DRC “conflict free” components and parts, and we may not be able to obtain DRC conflict free products or supplies in sufficient quantities for our operations. Since our supply chain is complex, we may face reputational challenges with our customers, stockholders and other stakeholders if we are unable to sufficiently verify the origins for the minerals used in our products.

If our security measures are breached, or if our services are subject to attacks that degrade or deny the ability of users to access our products and services, our products and services may be perceived as not being secure, users and customers may curtail or stop using our products and services, and we may incur significant legal and financial exposure.

Our products and services involve the storage and transmission of users' and customers' proprietary information, and security breaches expose us to a risk of loss of this information, litigation, and potential liability. We experience cyber attacks of varying degrees on a regular basis, and as a result, unauthorized parties have obtained, and may in the future obtain, access to our data or our users' or customers' data. Our security measures may also be breached due to employee error, malfeasance, or otherwise. Additionally, outside parties may attempt to fraudulently induce employees, users, or customers to disclose sensitive information in order to gain access to our data or our users' or customers' data. Any such breach or unauthorized access could result in significant legal and financial exposure, damage to our reputation, and a loss of confidence in the security of our products and services that could potentially have an adverse effect on our business. Because the techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems change frequently and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose users and customers.

Web spam and content farms could decrease our search quality, which could damage our reputation and deter our current and potential users from using our products and services.

“Web spam” refers to websites that attempt to violate a search engine's quality guidelines or that otherwise seek to rank higher in search results than a search engine's assessment of their relevance and utility would rank them. Although English-language web spam in our search results has been significantly reduced, and web spam in most other languages is limited, we expect web spammers will continue to seek ways to improve their rankings inappropriately. We continuously combat web spam, including through indexing technology that makes it harder for spam-like, less useful web content to rank highly. We face challenges from low-quality and irrelevant content websites, including “content farms”, which are websites that generate large quantities of low-quality content to help them improve their search rankings. We are continually launching algorithmic changes focused on low-quality websites. If web spam and content farms continue to increase on Google, this could hurt our reputation for delivering relevant information or reduce user traffic to our websites. In addition, as we continue to take actions to improve our search quality and reduce low-quality content, this may in the short run reduce our AdSense revenues, since some of these websites are AdSense partners.

Interruption or failure of our information technology and communications systems could hurt our ability to effectively provide our products and services, which could damage our reputation and harm our operating results.

The availability of our products and services depends on the continuing operation of our information technology and communications systems. Our systems are vulnerable to damage or interruption from earthquakes, terrorist attacks, floods, fires, power loss, telecommunications failures, computer viruses, computer denial of service attacks, or other attempts to harm our systems. Some of our data centers are located in areas with a high risk of major earthquakes. Our data centers are also subject to break-ins, sabotage, and intentional acts of vandalism, and to potential disruptions if the operators of certain of these facilities have financial difficulties. Some of our systems are not fully redundant, and our disaster recovery planning cannot account for all eventualities. The occurrence of a natural disaster, a decision to close a facility we are using without adequate notice for financial reasons, or other unanticipated problems at our data centers could result in lengthy interruptions in our service. In addition, our products and services are highly technical and complex and may contain errors or vulnerabilities. Any errors or vulnerabilities in our products and services, or damage to or failure of our systems, could result in interruptions in our services, which could reduce our revenues and profits, and damage our brand.

Our international operations expose us to additional risks that could harm our business, operating results, and financial condition.

Our international operations are significant to our revenues and net income, and we plan to continue to grow internationally. International revenues accounted for approximately 57% of our consolidated revenues in the three months ended March 31, 2014. In certain international markets, we have limited operating experience and may not benefit from any first-to-market advantages or otherwise succeed.

Most of our Motorola products are manufactured outside the U.S., primarily in China, Taiwan and Brazil. If our manufacturing in these countries is disrupted, our overall capacity could be reduced and sales or profitability could be negatively impacted. We require suppliers and business partners to comply with the law and company policies regarding workplace and employment practices, environmental compliance and intellectual property licensing, but we do not control them or their practices. If any of them violates laws or implements practices regarded as unethical, we could experience supply chain disruptions, canceled orders, terminations of or damage to key relationships, and damage to our reputation. If any of them fails to procure necessary license rights to third-party intellectual property, legal action could ensue that could impact the saleability of our products and expose us to financial obligations to third parties.

Moreover, in connection with Motorola Mobile's operations in Brazil, we have had and continue to have legal disputes and controversies, including tax, labor and trade compliance controversies and other legal matters that take many years to resolve. We incur legal and other costs in managing and defending these matters and expect to continue to incur such costs. Based on our assessment of these matters, we have recorded reserves on only a small portion of the total potential exposure. It is, however, very difficult to predict the outcome of legal disputes and controversies, including litigation, in Brazil and our ultimate exposure may be greater than our current assessments and related reserves.

In addition to risks described elsewhere in this section, our international operations expose us to other risks, including the following:

- Changes in local political, economic, social, and labor conditions, which may adversely harm our business.
- Restrictions on foreign ownership and investments, and stringent foreign exchange controls that might prevent us from repatriating cash earned in countries outside the U.S.
- Import and export requirements, tariffs, trade disputes and barriers, and customs classifications that may prevent us from offering products or providing services to a particular market and may increase our operating costs.
- Potential injunctions from importation into the U.S. of our Motorola products manufactured outside the U.S. in an ITC matter.
- Longer payment cycles in some countries, increased credit risk, and higher levels of payment fraud.
- Still developing foreign laws and legal systems.
- Uncertainty regarding liability for services and content, including uncertainty as a result of local laws and lack of legal precedent.
- Different employee/employer relationships, existence of workers' councils and labor unions, and other challenges caused by distance, language, and cultural differences, making it harder to do business in certain jurisdictions.

In addition, compliance with complex foreign and U.S. laws and regulations that apply to our international operations increases our cost of doing business. These numerous and sometimes conflicting laws and regulations include internal control and disclosure rules, data privacy and filtering requirements, anti-corruption laws, such as the Foreign Corrupt Practices Act, and other local laws prohibiting corrupt payments to governmental officials, and antitrust and competition regulations, among others. Violations of these laws and regulations could result in fines and penalties, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business and on our ability to offer our products and services in one or more countries, and could also materially affect our brand, our international expansion efforts, our ability to attract and retain employees, our business, and our operating results. Although we have implemented policies and procedures designed to ensure compliance with these laws and regulations, there can be no assurance that our employees, contractors, or agents will not violate our policies.

Finally, since we conduct business in currencies other than U.S. dollars but report our financial results in U.S. dollars, we face exposure to fluctuations in currency exchange rates. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net income. Additionally, hedging programs are inherently risky and could expose us to additional risks that could adversely affect our financial condition and results of operations.

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Our operating results may fluctuate, which makes our results difficult to predict and could cause our results to fall short of expectations.

Our operating results may fluctuate as a result of a number of factors, many outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful, and you should not rely on our past results as an indication of our future performance. Our quarterly, year-to-date, and annual expenses as a percentage of our revenues may differ significantly from our historical or projected rates. Our operating results in future quarters may fall below expectations. Any of these events could cause our stock price to fall. Each of the risk factors listed in this section in addition to the following factors may affect our operating results:

- Our ability to continue to attract users to our websites and satisfy existing users on our websites.
- Our ability to monetize (or generate revenues from) traffic on our websites and our Google Network Members' websites.
- Revenue fluctuations caused by changes in property mix, platform mix and geographical mix.
- The amount of revenues and expenses generated and incurred in currencies other than U.S. dollars, and our ability to manage the resulting risk through our foreign exchange risk management program.
- The amount and timing of operating costs and expenses and capital expenditures related to the maintenance and expansion of our businesses, operations, and infrastructure.
- Our focus on long-term goals over short-term results.
- The results of our investments in risky projects, including new businesses, products, services, technologies and acquisitions.
- Our ability to keep our websites operational at a reasonable cost and without service interruptions.
- Our ability to generate significant revenues from services in which we have invested considerable time and resources.

Because our business is changing and evolving, our historical operating results may not be useful to you in predicting our future operating results. In addition, advertising spending has historically been cyclical in nature, reflecting overall economic conditions, as well as budgeting and buying patterns. Also, user traffic tends to be seasonal. Our rapid growth has tended to mask the cyclicality and seasonality of our business. As our growth rate has slowed, the cyclicality and seasonality in our business has become more pronounced and caused our operating results to fluctuate.

If we were to lose the services of Larry, Sergey, Eric, or other key personnel, we may not be able to execute our business strategy.

Our future success depends in a large part upon the continued service of key members of our senior management team. In particular, Larry Page and Sergey Brin are critical to the overall management of Google and the development of our technology. Along with our Executive Chairman Eric E. Schmidt, they also play a key role in maintaining our culture and setting our strategic direction. All of our executive officers and key employees are at-will employees, and we do not maintain any key-person life insurance policies. The loss of key personnel could seriously harm our business.

We rely on highly skilled personnel and, if we are unable to retain or motivate key personnel, hire qualified personnel, or maintain our corporate culture, we may not be able to grow effectively.

Our performance largely depends on the talents and efforts of highly skilled individuals. Our future success depends on our continuing ability to identify, hire, develop, motivate, and retain highly skilled personnel for all areas of our organization. Competition in our industry for qualified employees is intense, and certain of our competitors have directly targeted our employees. In addition, our compensation arrangements, such as our equity award programs, may not always be successful in attracting new employees and retaining and motivating our existing employees. Our continued ability to compete effectively depends on our ability to attract new employees and to retain and motivate our existing employees.

In addition, we believe that our corporate culture fosters innovation, creativity, and teamwork. As our organization grows, and we are required to implement more complex organizational management structures, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. This could negatively impact our future success.

Our business depends on continued and unimpeded access to the internet by us and our users. Internet access providers may be able to block, degrade, or charge for access to certain of our products and services, which could lead to additional expenses and the loss of users and advertisers.

Our products and services depend on the ability of our users to access the internet, and certain of our products require significant bandwidth to work effectively. Currently, this access is provided by companies that have significant market power in the broadband and internet access marketplace, including incumbent telephone companies, cable companies, mobile communications companies, and government-owned service providers. Some of these providers have taken, or have stated that they may take measures, including legal actions, that could degrade, disrupt, or increase the cost of user access to certain of our products by restricting or prohibiting the use of their infrastructure to support or facilitate our offerings, or by charging increased fees to us or our users to provide our offerings. Such interference could result in a loss of existing users and advertisers, and increased costs, and could impair our ability to attract new users and advertisers, thereby harming our revenues and growth.

New technologies could block our ads, which would harm our business.

Technologies have been developed that can block the display of our ads and that provide tools to users to opt out of our advertising products. Most of our revenues are derived from fees paid to us by advertisers in connection with the display of ads on web pages for our users. As a result, such technologies and tools could adversely affect our operating results.

We are exposed to fluctuations in the market values of our investment portfolio.

Given the global nature of our business, we have investments both domestically and internationally. Credit ratings and pricing of these investments can be negatively impacted by liquidity, credit deterioration or losses, financial results, or other factors. As a result, the value or liquidity of our cash equivalents and marketable securities could decline and result in a material impairment, which could materially adversely affect our financial condition and operating results.

We may have exposure to greater than anticipated tax liabilities.

Our future income taxes could be adversely affected by earnings being lower than anticipated in jurisdictions that have lower statutory tax rates and higher than anticipated in jurisdictions that have higher statutory tax rates, by changes in the valuation of our deferred tax assets and liabilities, as a result of gains on our foreign exchange risk management program, or changes in tax laws, regulations, or accounting principles, as well as certain discrete items. We are subject to regular review and audit by both domestic and foreign tax authorities. Any adverse outcome of such a review or audit could have a negative effect on our operating results and financial condition. In addition, the determination of our worldwide provision for income taxes and other tax liabilities requires significant judgment, and there are many transactions and calculations where the ultimate tax determination is uncertain. Although we believe our estimates are reasonable, the ultimate tax outcome may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods for which such determination is made.

Risks Related to Ownership of Our Stock

The trading price for our Class A common stock may continue to be volatile and the trading price for our newly distributed non-voting Class C capital stock may also be volatile.

The trading price of our stock has at times experienced substantial price volatility and may continue to be volatile. For example, from January 1, 2014 through March 31, 2014, the pre-split closing price of our Class A common stock ranged from $1,101.23 per share to $1,220.17 per share.

In addition, following the settlement of litigation involving the authorization to distribute our non-voting Class C capital stock, our board of directors approved a distribution of shares of Class C capital stock as a dividend to our holders of Class A and Class B common stock with a payment date of April 2, 2014, and on April 3, 2014, Class C capital stock was listed on The NASDAQ Global Select Market. We expect that the market price for the shares of Class A common stock will continue to generally reflect the effect of a two-for-one stock split. In accordance with the settlement, we may be obligated to make a payment to holders of Class C capital stock if, on average, Class C capital stock trades below Class A common stock during the first 365 days following the Class C dividend. While we expect that the market price for the shares of Class A common stock and Class C capital stock will trade in roughly the same range, we cannot reliably predict what, if any, patterns will emerge over time with respect to the relative trading prices of Class A common stock and Class C capital stock, and we may be obligated to make such a payment to holders of the Class C stock in cash, Class A stock, Class C stock, or a combination thereof, at the discretion of the board of directors.

The trading price of our Class A common stock and Class C capital stock may fluctuate widely in response to various factors, some of which are beyond our control. These factors include, among others:

- Quarterly variations in our results of operations or those of our competitors.
- Announcements by us or our competitors of acquisitions, new products, significant contracts, commercial relationships, or capital commitments.
- Recommendations by securities analysts or changes in earnings estimates.
- Announcements about our earnings that are not in line with analyst expectations, the risk of which is enhanced because it is our policy not to give guidance on earnings.
- Announcements by our competitors of their earnings that are not in line with analyst expectations.
- Commentary by industry and market professionals about our products, strategies, and other matters affecting our business and results, regardless of its accuracy.
- The volume of shares of Class A common stock and Class C capital stock available for public sale.
- Sales of Class A common stock and Class C capital stock by us or by our stockholders (including sales by our directors, executive officers, and other employees).
- Short sales, hedging, and other derivative transactions on shares of our Class A common stock and Class C capital stock.
- The perceived values of Class A common stock and Class C capital stock relative to one another.

In addition, the stock market in general, and the market for technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may harm the market price of our Class A common stock and our Class C capital stock regardless of our actual operating performance.

The concentration of our stock ownership limits our stockholders' ability to influence corporate matters.

Our Class B common stock has 10 votes per share, our Class A common stock has one vote per share, and our Class C capital stock has no voting rights. As of March 31, 2014, Larry, Sergey, and Eric beneficially owned approximately 92.2% of our outstanding Class B common stock and represented approximately 61.3% of the voting power of our outstanding capital stock. Larry, Sergey, and Eric therefore have significant influence over management and affairs and over all matters requiring stockholder approval, including the election of directors and significant corporate transactions, such as a merger or other sale of our company or our assets, for the foreseeable future. In addition, because our Class C capital stock carries no voting rights (except as required by applicable law), the issuance of the Class C capital stock, including in future stock-based acquisition transactions and to fund employee equity incentive programs, could prolong the duration of Larry and Sergey’s current relative ownership of our voting power and their ability to elect all of our directors and to determine the outcome of most matters submitted to a vote of our stockholders. Together with Eric, they would also continue to be able to control any required stockholder vote with respect to certain change in control transactions involving Google (including an acquisition of Google by another company).

This concentrated control limits or severely restricts our stockholders' ability to influence corporate matters and, as a result, we may take actions that our stockholders do not view as beneficial. As a result, the market price of our Class A common stock and our Class C capital stock could be adversely affected.

Provisions in our charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

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- Our certificate of incorporation provides for a tri-class capital stock structure. As a result of this structure, Larry, Sergey, and Eric have significant influence over all matters requiring stockholder approval, including the election of directors and significant corporate transactions, such as a merger or other sale of our company or our assets. This concentrated control could discourage others from initiating any potential merger, takeover, or other change of control transaction that other stockholders may view as beneficial. As noted above, the issuance of the Class C capital stock could have the effect of prolonging the influence of Larry, Sergey, and Eric.
- Our board of directors has the right to elect directors to fill a vacancy created by the expansion of the board of directors or the resignation, death, or removal of a director, which prevents stockholders from being able to fill vacancies on our board of directors.
- Our stockholders may not act by written consent. As a result, a holder, or holders, controlling a majority of our capital stock would not be able to take certain actions without holding a stockholders' meeting.
- Our certificate of incorporation prohibits cumulative voting in the election of directors. This limits the ability of minority stockholders to elect director candidates.
- Stockholders must provide advance notice to nominate individuals for election to the board of directors or to propose matters that can be acted upon at a stockholders' meeting. These provisions may discourage or deter a potential acquirer from conducting a solicitation of proxies to elect the acquirer's own slate of directors or otherwise attempting to obtain control of our company.
- Our board of directors may issue, without stockholder approval, shares of undesignated preferred stock. The ability to issue undesignated preferred stock makes it possible for our board of directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us.

As a Delaware corporation, we are also subject to certain Delaware anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its outstanding voting stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on Delaware law to prevent or delay an acquisition of us.

ITEM 6. EXHIBITS

See the Exhibit Index following the signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

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SIGNATURE

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

		GOOGLE INC.
Date: April 24, 2014	By:	/s/ PATRICK PICHETTE
		Patrick Pichette
		Senior Vice President and Chief Financial Officer
		(Principal financial officer and duly authorized signatory)

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EXHIBIT INDEX

Exhibit Number		Description	Incorporated by reference herein Form	Date
4.01		Form of 3.375% Note due 2024	Current Report on Form 8-K (File No. 000-50726)	February 25, 2014
4.02		Transfer Restriction Agreement, dated March 25, 2014, between Google Inc. and Larry Page	Current Report on Form 8-K (File No. 000-50726)	March 26, 2014
4.03		Transfer Restriction Agreement, dated March 25, 2014, between Google Inc. and Sergey Brin	Current Report on Form 8-K (File No. 000-50726)	March 26, 2014
4.04		Transfer Restriction Agreement, dated March 25, 2014, between Google Inc. and Eric E. Schmidt and certain of his affiliates	Current Report on Form 8-K (File No. 000-50726)	March 26, 2014
4.05		Specimen Class A Common Stock certificate	Registration Statement on Form 8-A (File No. 001-36380)	March 26, 2014
4.06		Specimen Class B Common Stock certificate	Registration Statement on Form 8-A (File No. 001-36380)	March 26, 2014
4.07		Specimen Class C Capital Stock certificate	Registration Statement on Form 8-A (File No. 001-36380)	March 26, 2014
4.08		Terms of Revised Settlement of In Re: Google Inc. Class C Shareholder Litigation (Consol. C.A. No. 7469-CS)	Registration Statement on Form 8-A (File No. 001-36380)	March 26, 2014
12	*	Computation of Ratio of Earnings to Fixed Charges		
31.01	*	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		
31.02	*	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		
32.01	‡	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002		
101.INS		XBRL Instance Document		
101.SCH		XBRL Taxonomy Extension Schema Document		
101.CAL		XBRL Taxonomy Extension Calculation Linkbase Document		
101.DEF		XBRL Taxonomy Extension Definition Linkbase Document		
101.LAB		XBRL Taxonomy Extension Label Linkbase Document		
101.PRE		XBRL Taxonomy Extension Presentation Linkbase Document		

* Filed herewith.

‡ Furnished herewith.