EBAY INC
Form 10-Q/A
April 26, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q/A
(Amendment No. 1)

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

For the quarterly period ended March 31, 2006

or

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

For the transition period from to

Commission file number 000-24821
eBay Inc.
(Exact name of registrant as specified in its charter)

Delaware	**74-0430924**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
2145 Hamilton Avenue San Jose, California	**95125**
(Address of principal executive offices)	*(Zip Code)*

(408) 376-7400
(Registrant s telephone number, including area code)

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

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

As of April 21, 2006, there were 1,410,109,123 shares of the registrant s common stock, $0.001 par value, outstanding, which is the only class of common or voting stock of the registrant issued.

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EXPLANATORY NOTE

eBay Inc. is filing this Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006, as filed with the Securities and Exchange Commission on April 24, 2006, to correct an error in our narrative description of the impact of foreign currency exchange rates on net revenues and operating expenses during the first quarter of 2006, as compared to the same period of the prior year, on pages 25, 26, 31, and 42 of the Quarterly Report. eBay Inc. s previously filed financial statements remain unchanged.

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PART I: FINANCIAL INFORMATION

Item 1: ***Financial Statements***

eBay Inc.
CONDENSED CONSOLIDATED BALANCE SHEET

	December 31, 2005	March 31, 2006
	(In thousands, except par value amounts) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,313,580	$ 1,876,434
Short-term investments	774,650	828,049
Accounts receivable, net	322,788	318,878
Funds receivable from customers	255,282	225,295
Restricted cash and investments	29,702	30,755
Other current assets	487,235	620,832
Total current assets	3,183,237	3,900,243
Long-term investments	825,667	793,497
Property and equipment, net	801,602	860,493
Goodwill	6,120,079	6,205,075
Intangible assets, net	823,280	781,988
Other assets	35,121	27,239
Total assets	$ 11,788,986	$ 12,568,535
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 55,692	$ 101,157
Funds payable and amounts due to customers	586,651	660,838
Accrued expenses and other current liabilities	578,557	589,665
Deferred revenue and customer advances	81,940	90,965
Income taxes payable	182,095	238,883
Total current liabilities	1,484,935	1,681,508
Deferred tax liabilities, net	215,682	220,430
Other liabilities	40,388	39,797
Total liabilities	1,741,005	1,941,735
Stockholders equity:		
Common Stock, $0.001 par value; 3,580,000 shares authorized; 1,404,183 and 1,409,069 shares issued and outstanding	1,404	1,409
Additional paid-in capital	7,272,476	7,429,377
Unearned stock-based compensation	(45,540)	

Retained earnings	2,716,511	2,964,793
Accumulated other comprehensive income	103,130	231,221
Total stockholders equity	10,047,981	10,626,800
Total liabilities and stockholders equity	$ 11,788,986	$ 12,568,535

The accompanying notes are an integral part of these condensed consolidated financial statements.

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eBay Inc.
CONDENSED CONSOLIDATED STATEMENT OF INCOME

	Three Months Ended March 31,	
	2005	2006
	(In thousands, except per share amounts) (Unaudited)	
Net revenues	$ 1,031,724	$ 1,390,419
Cost of net revenues(1)	186,369	278,568
Gross profit	845,355	1,111,851
Operating expenses(1):		
Sales and marketing	271,349	400,562
Product development	73,789	119,070
General and administrative	136,389	215,350
Payroll tax on employee stock options	5,731	2,324
Amortization of acquired intangible assets	22,523	51,921
Total operating expenses	509,781	789,227
Income from operations	335,574	322,624
Interest and other income, net	22,403	25,760
Interest expense	(1,720)	(747)
Income before income taxes and minority interests	356,257	347,637
Provision for income taxes	(99,948)	(99,354)
Minority interests	(18)	(1)
Net income	$ 256,291	$ 248,282
Net income per share:		
Basic	$ 0.19	$ 0.18
Diluted	$ 0.19	$ 0.17
Weighted average shares:		
Basic	1,343,442	1,406,309
Diluted	1,382,150	1,437,581
(1) Includes stock-based compensation as follows (2006 increases are due primarily to the adoption of FAS 123(R)):		
Cost of net revenues	$ 78	$ 9,476
Sales and marketing		24,721

Product development		322		20,701
General and administrative		3,196		28,920
Total stock-based compensation	$	3,596	$	83,818

The accompanying notes are an integral part of these condensed consolidated financial statements.

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eBay Inc.
CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Three Months Ended March 31,	
	2005	2006
	(In thousands) (Unaudited)	
Net income	$ 256,291	$ 248,282
Other comprehensive income (loss):		
Foreign currency translation	(13,687)	127,533
Unrealized gains (losses) on investments, net	(4,818)	2,592
Unrealized gains (losses) on cash flow hedges	1,414	(1,564)
Estimated tax benefit (provision)	1,314	(470)
Net change in accumulated other comprehensive income (loss)	(15,777)	128,091
Comprehensive income	$ 240,514	$ 376,373

The accompanying notes are an integral part of these condensed consolidated financial statements.

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eBay Inc.
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2006
	(In thousands) (Unaudited)	
Cash flows from operating activities:		
Net income	$ 256,291	$ 248,282
Adjustments:		
Provision for doubtful accounts and authorized credits	22,024	27,047
Provision for transaction losses	18,579	25,627
Depreciation and amortization	79,660	123,286
Stock based compensation expense related to stock options and employee stock purchases	3,596	83,818
Tax benefit on the exercise of employee stock options	84,992	37,442
Excess tax benefits from stock-based compensation		(23,372)
Minority interests	18	1
Changes in assets and liabilities, net of acquisition effects:		
Accounts receivable	(54,162)	(22,901)
Funds receivable from customers	(77,333)	29,748
Other current assets	1,203	(117,726)
Other non-current assets	(8,361)	7,263
Deferred tax liabilities, net	2,240	(7,500)
Accounts payable	20,909	51,956
Funds payable and amounts due to customers	168,928	74,331
Accrued expenses and other liabilities	(21,838)	(18,761)
Deferred revenue and customer advances	(6,975)	9,023
Income taxes payable	5,648	56,640
Net cash provided by operating activities	495,419	584,204
Cash flows from investing activities:		
Purchases of property and equipment, net	(79,584)	(133,576)
Purchases of investments	(368,094)	(378,087)
Maturities and sales of investments	245,665	365,777
Acquisitions, net of cash acquired	(445,008)	
Net cash used in investing activities	(647,021)	(145,886)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	179,279	80,606
Excess tax benefits from stock-based compensation		23,372
Payment of headquarters lease facility obligation	(126,390)	
Principal payments on long-term obligations	(1,849)	

Net cash provided by financing activities	51,040	103,978
Effect of exchange rate changes on cash and cash equivalents	(12,711)	20,558
Net increase (decrease) in cash and cash equivalents	(113,273)	562,854
Cash and cash equivalents at beginning of period	1,330,045	1,313,580
Cash and cash equivalents at end of period	$ 1,216,772	$ 1,876,434

The accompanying notes are an integral part of these condensed consolidated financial statements.

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 The Company and Summary of Significant Accounting Policies

The Company

eBay Inc. (eBay) was incorporated in California in May 1996, and reincorporated in Delaware in April 1998. eBay, together with its subsidiaries, pioneers new communities around the world, built on commerce, sustained by trust, and inspired by opportunity. eBay brings together millions of buyers and sellers every day on a local, national and international basis through an array of websites. eBay provides online marketplaces for the sale of goods and services, online payment services and online communication offerings to a diverse community of individuals and businesses.

eBay currently has three primary businesses: the eBay Marketplaces, Payments and Communications. The eBay Marketplaces segments provide the infrastructure to enable online commerce in a variety of formats, including the traditional auction platform, along with our other online platforms, such as Rent.com, Shopping.com, Kijiji, mobile.de, and Marktplaats.nl. The Payments segment, which consists of our PayPal, Inc. (PayPal) business, enables individuals or businesses to securely, easily and quickly send and receive payments online. The Communications segment, which consists of our Skype Technologies SA (Skype) business, enables Voice over Internet Protocol (VoIP) calls between Skype users, as well as provides low-cost connectivity to traditional fixed-line and mobile telephones.

When we refer to we, our, us or eBay in this document, we mean the current Delaware corporation (eBay Inc.) its California predecessor, as well as all of our consolidated subsidiaries.

Use of estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those related to provisions for doubtful accounts and authorized credits, the provision for transaction losses, legal contingencies, income taxes, advertising and other non-transaction revenues, stock-based compensation expense and goodwill and intangible assets. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results could differ from those estimates.

Principles of consolidation and basis of presentation

The accompanying financial statements are consolidated and include the financial statements of eBay and our majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements include 100% of the assets and liabilities of these majority-owned subsidiaries and the ownership interests of minority investors are recorded as minority interests. Investments in entities where we hold more than a 20% but less than a 50% ownership interest and have the ability to significantly influence the operations of the investee are accounted for using the equity method of accounting and the investment balance is included in long-term investments, while our share of the investees results of operations is included in interest and other income, net. For the three month period ended March 31, 2006 and 2005, the equity method income recorded in interest and other income, net were not material to the Company s operating results. Investments in entities where we hold less than a 20% ownership interest and where we do not have the ability to significantly influence the operations of the investee are accounted for using the cost method of accounting and are included in long-term investments.

eBay Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

These unaudited interim financial statements reflect our condensed consolidated financial position as of December 31, 2005 and March 31, 2006. These statements also show our condensed consolidated statement of income for the three months ended March 31, 2005 and 2006 and our condensed consolidated statement of cash flows for the three months ended March 31, 2005 and 2006. These statements include all normal recurring adjustments that we believe are necessary to fairly state our financial position, operating results and cash flows. Because all of the disclosures required by generally accepted accounting principles in the United States of America for annual consolidated financial statements are not included herein, these interim financial statements should be read in conjunction with the audited financial statements and the notes thereto for the year ended December 31, 2005, included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 23, 2006. The condensed consolidated statements of income and cash flows for the periods presented are not necessarily indicative of results that we expect for any future period.

Certain prior period balances have been reclassified to conform to the current period presentation.

Stock-based compensation

On January 1, 2006, we adopted Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123(R)), that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise s equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions, as we formerly did, using the intrinsic value method as prescribed by Accounting Principles Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees, and generally requires that such transactions be accounted for using a fair-value-based method and recognized as expenses in our consolidated statement of income.

We adopted FAS 123(R) using the modified prospective method which requires the application of the accounting standard as of January 1, 2006. Our consolidated financial statements as of and for the first quarter of 2006 reflect the impact of adopting FAS 123(R). In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of FAS 123(R). See Note 7 Stock-based Benefit Plans for further details.

Stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the condensed consolidated statement of operations during the first quarter of 2006 included compensation expense for stock-based payment awards granted prior to, but not yet vested, as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of FAS 148 and compensation expense for the stock-based payment awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with FAS 123(R). As stock-based compensation expense recognized in the statement of income for the first quarter of 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. FAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information required under FAS 148 for the periods prior to 2006, we accounted for forfeitures as they occurred.

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eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2 Net Income Per Share

Basic net income per share is computed by dividing the net income for the period by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the weighted average number of shares of common stock and potentially dilutive common stock outstanding during the period. The dilutive effect of outstanding options and restricted stock is reflected in diluted earnings per share by application of the treasury stock method, which in the current period includes consideration of stock-based compensation required by FAS 123(R). The following table sets forth the computation of basic and diluted net income per share for the periods indicated (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2005	2006
Numerator:		
Net income	$ 256,291	$ 248,282
Denominator:		
Weighted average common shares	1,343,582	1,406,449
Weighted average unvested restricted common stock subject to repurchase	(140)	(140)
Denominator for basic calculation	1,343,442	1,406,309
Weighted average effect of dilutive securities:		
Weighted average unvested restricted common stock subject to repurchase	140	140
Employee stock options	38,568	31,132
Denominator for diluted calculation	1,382,150	1,437,581
Net income per share:		
Basic	$ 0.19	$ 0.18
Diluted	$ 0.19	$ 0.17

The calculation of diluted net income per share excludes all anti-dilutive shares. For the three months ended March 31, 2005 and 2006, the number of anti-dilutive shares, as calculated based on the weighted average closing price of our common stock for the period, amounted to approximately 15.8 million and 36.8 million shares, respectively.

Note 3 Business Combinations, Goodwill and Intangible Assets

The following table presents goodwill balances and the movements for each of our reportable segments during the three months ended March 31, 2006 (in thousands):

	December 31, 2005	Goodwill Acquired	Adjustments	March 31, 2006
Reportable segments:				
U.S. Marketplaces	$ 961,081	$	$ (6,849)	$ 954,232

International Marketplaces	1,525,789		35,876	1,561,665
Payments	1,348,385		53	1,348,438
Communications	2,312,184		55,916	2,368,100
	$ 6,147,439	$	$ 84,996	$ 6,232,435

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Adjustments to goodwill during the three months ended March 31, 2006, resulted primarily from foreign currency translation adjustments and purchase price adjustments related to deferred tax assets.

Investments accounted for under the equity method of accounting are classified on our balance sheet as long-term investments. Such investments include identifiable intangible assets, deferred tax liabilities and goodwill. As of December 31, 2005 and March 31, 2006, the goodwill related to our equity investment totaled approximately $27.4 million.

In accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (FAS 142), goodwill is subject to at least an annual assessment for impairment, applying a fair-value based test. We conduct our annual impairment test as of August 31 of each year. Based on our last impairment test as of August 31, 2005 we determined there was no impairment. There were no events or circumstances from that date through March 31, 2006 indicating that a further assessment was necessary.

Intangible Assets

The components of acquired identifiable intangible assets are as follows (dollars in thousands):

	December 31, 2005				March 31, 2006			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Economic Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Economic Life (Years)
Intangible assets:								
Customer lists and user base	$ 526,657	$ (145,397)	$ 381,260	6	$ 530,264	$ (170,417)	$ 359,847	6
Trademarks and trade names	443,565	(75,571)	367,994	5	451,354	(98,629)	352,725	5
Developed technologies	101,971	(45,882)	56,089	4	100,931	(49,706)	51,225	4
All other	36,450	(14,761)	21,689	4	38,325	(16,671)	21,654	4
	$ 1,108,643	$ (281,611)	$ 827,032		$ 1,120,874	$ (335,423)	$ 785,451	

All of our acquired identifiable intangible assets are subject to amortization. As of December 31, 2005 and March 31, 2006, the net carrying amount of intangible assets related to our equity investment totaled approximately $3.8 million and $3.5 million respectively. Aggregate amortization expense for intangible assets totaled $23.9 million and $53.4 million for the three months ended March 31, 2005 and 2006, respectively.

As of March 31, 2006, expected future intangible asset amortization is as follows (in thousands):

Fiscal Years:	
2006 (remaining nine months)	$ 147,301
2007	188,257
2008	180,600
2009	162,128

2010	90,212
Thereafter	16,953
	$ 785,451

On April 24, 2006, we acquired all equity securities of Tradera.com, the leading online auction-style marketplace in Sweden for approximately 365 million Swedish Kronor, plus acquisition costs and an adjustment for net cash acquired. Based on an April 21, 2006 exchange rate of SEK 7.56 to US$1.00, the net purchase amount approximates $48 million.

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4 Segments

Reporting segments are based upon our internal organization structure, the manner in which our operations are managed, the criteria used by our chief operating decision-maker to evaluate segment performance, the availability of separate financial information, and overall materiality considerations.

The U.S. Marketplaces segment includes our U.S. online marketplaces commerce platforms. The International Marketplaces segment includes our international online marketplaces commerce platforms. The Payments segment includes our global payments platform, consisting of our PayPal subsidiary. The Communications segment includes the VoIP offerings provided by our Skype subsidiary. Results from our Communications segment reflect Skype operations for the post-acquisition period from October 15, 2005.

Direct contribution consists of revenues less direct costs. Direct costs include specific costs of net revenues, sales and marketing expenses, and general and administrative expenses over which segment managers have direct discretionary control, such as advertising and marketing programs, customer support expenses, bank charges, transaction expenses, provisions for doubtful accounts, authorized credits and transaction losses. Expenses over which segment managers do not currently have discretionary control, such as certain general and administrative costs, amortization of acquired intangible assets and stock-based compensation expenses, are monitored by management through shared cost centers and are not evaluated in the measurement of segment performance. Prior period amounts have been reclassified to reflect the current management of site operations cost and product development expenses as direct costs.

The following table summarizes our financial performance (in thousands):

	Three Months Ended March 31, 2005			
	U.S. Marketplaces	International Marketplaces	Payments	Consolidated
Net revenues from external customers	$ 404,848	$ 393,792	$ 233,084	$ 1,031,724
Direct costs	244,592	194,324	159,969	598,885
Direct contribution	$ 160,256	$ 199,468	$ 73,115	$ 432,839
Operating expenses and indirect costs of net revenues				97,265
Income from operations				335,574
Interest and other income, net				22,403
Interest expense				(1,720)
Income before income taxes and minority interests				$ 356,257

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eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended March 31, 2006				
	U.S. Marketplaces	International Marketplaces	Payments	Communications	Consolidated
Net revenues from external customers	$ 527,220	$ 492,973	$ 335,066	$ 35,160	$ 1,390,419
Direct costs	317,516	254,870	248,412	44,008	864,806
Direct contribution	$ 209,704	$ 238,103	$ 86,654	$ (8,848)	$ 525,613
Operating expenses and indirect costs of net revenues					202,989
Income from operations					322,624
Interest and other income, net					25,760
Interest expense					(747)
Income before income taxes and minority interests					$ 347,637

Note 5 Balance Sheet Components

At December 31, 2005 and March 31, 2006, short and long-term investments were classified as available-for-sale securities, except for restricted cash and investments, and were reported at fair value as follows (in thousands):

	December 31, 2005			
	Gross Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Short-term investments:				
Restricted cash and investments	$ 29,670	$ 32	$	$ 29,702
Corporate debt securities	362,438	4	(2,679)	359,763
Government and agency securities	371,537		(3,198)	368,339
Time deposits and other	46,548			46,548
	$ 810,193	$ 36	$ (5,877)	$ 804,352
Long-term investments:				
Restricted cash and investments	$ 1,065	$	$	$ 1,065
Corporate debt securities	665,418	115	(1,921)	663,612
Government and agency securities	110,450		(1,409)	109,041
Equity instruments and equity method investments	51,949			51,949

$	828,882	$	115	$	(3,330)	$	825,667

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eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	March 31, 2006			
	Gross Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Short-term investments:				
Restricted cash and investments	$ 30,717	$ 38	$	$ 30,755
Corporate debt securities	370,018	16	(2,669)	367,365
Government and agency securities	420,367		(2,733)	417,634
Time deposits and other	43,050			43,050
	$ 864,152	$ 54	$ (5,402)	$ 858,804
Long-term investments:				
Restricted cash and investments	$ 1,071	$	$	$ 1,071
Corporate debt securities	699,686	136	(999)	698,823
Government and agency securities	34,985	6	(45)	34,946
Equity instruments and equity method investments	58,657			58,657
	$ 794,399	$ 142	$ (1,044)	$ 793,497

Other Current Assets

	December 31, 2005	March 31, 2006
	(In thousands)	
Customer accounts	$ 324,595	$ 429,266
Prepaid expenses	44,610	54,698
Deferred tax asset, net	59,274	75,543
Other	58,756	61,325
	$ 487,235	$ 620,832

Customer accounts include liquid assets set aside for certain customer liabilities as required in conjunction with PayPal s Electronic Money Institution license from the United Kingdom s Financial Services Authority. The customer liabilities represent claims on PayPal s U.K. subsidiary and may be invested only in specified types of liquid assets. These assets are included on our balance sheet as current assets with an offsetting current liability in funds payable and amounts due to customers. All customer funds held by PayPal as an agent or custodian, for the benefit of its customers and, accordingly, are not reflected in our consolidated balance sheet. These balances include funds held in the U.S. which are deposited in accounts insured by the Federal Deposit Insurance Corporation.

Note 6 Litigation and Other Contingencies

Litigation and Other Legal Matters

In April 2001, two of our European subsidiaries, eBay GmbH and eBay International AG, were sued by Montres Rolex S.A. and certain of its affiliates in the regional court of Cologne, Germany. The suit subsequently was transferred to the regional court in Düsseldorf, Germany. Rolex alleged that our subsidiaries were infringing Rolex s trademarks as a result of users selling counterfeit Rolex watches through our German website. The suit also alleged unfair competition. Rolex sought an order enjoining the sale of Rolex-branded watches on the website as well as damages. In December 2002, a trial was held in the matter and the court ruled in favor of eBay on all causes of action. Rolex appealed the ruling to the Higher Regional Court of

eBay Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Düsseldorf, and the appeal was heard in October 2003. In February 2004, the court rejected Rolex s appeal and ruled in our favor. Rolex has appealed the ruling to the German Federal Supreme Court, and a hearing is expected in December 2006. In September 2004, the German Federal Supreme Court issued its written opinion in favor of Rolex in a case involving an unrelated company, ricardo.de AG, but somewhat comparable legal theories. Although it is not yet clear what the ultimate effect of the reasoning of the German Federal Supreme Court s ricardo.de decision will have when applied to eBay, we believe the Court s decision has resulted in an increase in similar litigation against us in Germany, although we do not currently believe that it will require a significant change in our business practices.

In September 2001, MercExchange LLC filed a complaint against us, our Half.com subsidiary and ReturnBuy, Inc. in the U.S. District Court for the Eastern District of Virginia (No. 2:01-CV-736) alleging infringement of three patents (relating to online consignment auction technology, multiple database searching and electronic consignment systems) and seeking a permanent injunction and damages (including treble damages for willful infringement). In October 2002, the court granted in part our summary judgment motion, effectively invalidating the patent related to online auction technology and rendering it unenforceable. This ruling left only two patents in the case. Trial of the matter began in April 2003. In May 2003, the jury returned a verdict finding that eBay had willfully infringed one and Half.com had willfully infringed both of the patents in the suit, awarding $35 million in compensatory damages. Both parties filed post-trial motions, and in August 2003, the court entered judgment for MercExchange in the amount of approximately $30 million plus pre-judgment interest and post-judgment interest in an amount to be determined, while denying MercExchange s request for an injunction and attorneys fees. We appealed the verdict and judgment in favor of MercExchange and MercExchange filed a cross-appeal of the granting in part of our summary judgment motion and the denial of its request for an injunction and attorneys fees.

In March 2005, the U.S. Court of Appeals for the Federal Circuit issued a ruling in the appeal of the MercExchange patent litigation suit which, among other things (1) invalidated all claims asserted against eBay and Half.com arising out of the multiple database search patent and reduced the verdict amount by $4.5 million; (2) upheld the electronic consignment system patent; (3) affirmed the district court s refusal to award attorneys fees or enhanced damages against us; (4) reversed the district court s order granting summary judgment in our favor regarding the auction patent; and (5) reversed the district court s refusal to grant an injunction and remanded that issue to the district court for further proceedings. In May 2005, the Court of Appeals for the Federal Circuit granted our petition to stay the mandate in the case in order to allow us to petition the U.S. Supreme Court for review on certain issues. We filed our petition for review with the U.S. Supreme Court in July 2005, and in November 2005, the Court granted our petition for review. Oral arguments in the case were heard by the Court in March 2006, and the Court s decision is expected in the second quarter of 2006. In parallel with the federal court proceedings, at our request, the U.S. Patent and Trademark Office is actively reexamining each of the patents in suit, having found that substantial questions exist regarding the validity of the claims contained in them. In January 2005, the Patent and Trademark Office issued an initial ruling rejecting all of the claims contained in the patent that related to online auctions; in March 2005, the Patent and Trademark Office issued an initial ruling rejecting all of the claims contained in the patent that related to electronic consignment systems; and in May 2005, the Patent and Trademark Office issued an initial ruling rejecting all of the claims contained in the patent that related to multiple database searching. In March 2006, the Patent and Trademark Office affirmed its earlier ruling rejecting the claims contained in the patent that related to electronic consignment systems. Even if successful, our litigation of these matters will continue to be costly. In addition, as a precautionary measure, we have modified certain functionality of our websites and business practices in a manner which we believe would avoid any further infringement. For this reason, we believe that any injunction that might be issued by the district court will not have any impact on our business. We also believe we have appropriate reserves for this litigation. Nonetheless, if we are not successful in appealing or modifying the court s ruling, and if the modifications to the functionality of our websites and business practices are not sufficient to make them non-infringing, we would

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likely be forced to pay significant additional damages and licensing fees and/or modify our business practices in an adverse manner.

In August 2002, Charles E. Hill & Associates, Inc. filed a lawsuit in the U.S. District Court for the Eastern District of Texas (No. 2:02-CV-186) alleging that we and 17 other companies, primarily large retailers, infringed three patents owned by Hill generally relating to electronic catalog systems and methods for transmitting and updating data at a remote computer. The suit seeks an injunction against continuing infringement, unspecified damages, including treble damages for willful infringement, and interest, costs, expenses, and fees. The case was transferred to the U.S. District Court for the Southern District of Indiana in January 2003, but was transferred back to the U.S. District Court for the Eastern District of Texas in December 2003. A claim construction hearing was held in August 2005. In February 2006, we entered into and paid for a settlement agreement with the plaintiffs in the case under which we will be licensed under all of the patents at issue.

In February 2002, PayPal was sued in California state court (No. CV-805433) in a purported class action alleging that its limiting access to customer accounts and failure to promptly restore access to legitimate accounts violates California state consumer protection laws and is an unfair business practice and a breach of PayPal s User Agreement. This action was re-filed with a different named plaintiff in June 2002 (No. CV-808441), and a similar action was also filed in the U.S. District Court for the Northern District of California in June 2002 (No. C-02-2777). In March 2002, PayPal was sued in the U.S. District Court for the Northern District of California (No. C-02-1227) in a purported class action alleging that its limiting access to customer accounts and failure to promptly restore access to legitimate accounts violates federal and state consumer protection and unfair business practice laws. The two federal court actions were consolidated into a single case, and the state court action was stayed pending developments in the federal case. In June 2004, the parties announced that they had reached a proposed settlement. The settlement received approval from the federal court on November 2, 2004, and the state court action was dismissed with prejudice in March 2005. In the settlement, PayPal does not acknowledge that any of the allegations in the case are true. Under the terms of the settlement, certain PayPal account holders are eligible to receive payment from a settlement fund of $9.25 million, less administrative costs and the amount awarded to plaintiffs counsel by the court. That sum is being distributed to class members who have submitted timely claims in accordance with the settlement s plan of allocation. The plan of allocation for the portion of the settlement fund that remains undistributed was approved by the District Court in March 2006. Substantially all of the cost associated with the settlement was recognized in 2003.

In July 2004, a purported class action lawsuit was filed by two eBay users in Superior Court of the State of California, County of Santa Clara (No. 104CV022708) alleging that eBay engaged in improper billing practices as the result of problems with the rollout of a new billing software system in the second and third quarters of 2004. The lawsuit sought damages and injunctive relief. An amended complaint was filed in January 2005, dropping one plaintiff, changing the capacity of the other plaintiff to that of representative plaintiff, and adding seven additional eBay users as plaintiffs. The amended complaint expanded its claim to include numerous alleged improper billing practices from September 2003 until the present. In February 2005, eBay filed a motion to strike and a demurrer seeking to dismiss the complaint. In April 2005, the court sustained portions of the demurrer, but granted the plaintiffs leave to amend their complaint. The plaintiffs filed a second amended complaint, dropping the last original plaintiff and again adding new plaintiffs. We filed a motion to strike and a demurrer regarding the plaintiffs second amended complaint. In July 2005, the court again sustained a portion of the demurrer and again granted the plaintiffs leave to amend their complaint, and the plaintiffs filed a third amended complaint. In December 2005, the plaintiffs filed a fourth amended complaint, dropping several plaintiffs. In April 2006, the court approved a settlement agreement entered into by the parties. Under the terms of the settlement, the plaintiffs agreed to dismiss the lawsuit and release eBay from all claims, and eBay agreed to make a $250,000 payment primarily directed to charity. The estimated settlement was accrued in our consolidated income statement for the three months ended March 31, 2006.

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In February 2005, eBay was sued in Superior Court of the State of California, County of Santa Clara (No. 105CV035930) in a purported class action alleging that certain bidding features of our site constitute shill bidding for the purpose of artificially inflating bids placed by buyers on the site. The complaint alleges violations of California s Auction Act, California s Consumer Remedies Act, and unfair competition. The complaint seeks injunctive relief, damages, and a constructive trust. In April 2005, we filed a demurrer seeking to dismiss the complaint, and a hearing on the demurrer was held in February 2006. In March 2006, the parties reached tentative agreement on the terms of a settlement. The court must approve the terms of the settlement in order for it to become final. The estimated settlement was accrued in our consolidated income statement for the year ended December 31, 2005.

In March 2005, eBay, PayPal, and an eBay seller were sued in Supreme Court of the State of New York, County of Kings (No. 6125/05) in a purported class action alleging that certain disclosures regarding PayPal s Buyer Protection Policy, users chargeback rights, and the effects of users choice of funding mechanism are deceptive and/or misleading. The complaint alleged misrepresentation on the part of eBay and PayPal, breach of contract and deceptive trade practices by PayPal, and that PayPal and eBay have jointly violated the civil RICO statute (18 U.S.C. Section 1961(4)). In April 2005, eBay and PayPal removed the case to the U.S. District Court for the Eastern District of New York and the plaintiffs filed an amended complaint in the U.S. District Court (No. 05-CV-01720) repeating the allegations of the initial complaint but dropping the civil RICO allegations. The complaint seeks injunctive relief, compensatory damages, and punitive damages. Following several mediation sessions, the parties reached a tentative settlement in December 2005 and executed a Memorandum of Understanding in March 2006. The parties are engaged in the process of finalizing the settlement documentation. The court must approve the terms of the settlement in order for it to become final. The estimated settlement was accrued in our consolidated income statement for the year ended December 31, 2005.

Other third parties have from time to time claimed, and others may claim in the future, that we have infringed their intellectual property rights. We have been notified of several potential patent disputes, and expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity. In particular, we expect to face additional patent infringement claims involving services we provide, including various aspects of our Payments and Communications businesses. We have in the past been forced to litigate such claims. We may also become more vulnerable to third-party claims as laws such as the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are interpreted by the courts and as we expand geographically into jurisdictions where the underlying laws with respect to the potential liability of online intermediaries like ourselves are either unclear or less favorable. These claims, whether meritorious or not, could be time consuming and costly to resolve, cause service upgrade delays, require expensive changes in our methods of doing business, or could require us to enter into costly royalty or licensing agreements.

From time to time, we are involved in other disputes or regulatory inquiries that arise in the ordinary course of business. The number and significance of these disputes and inquiries are increasing as our business expands and our company grows larger. Any claims or regulatory actions against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, and result in the diversion of significant operational resources.

Indemnification Provisions

In the ordinary course of business, we have included limited indemnification provisions in certain of our agreements with parties with whom we have commercial relations, including our standard marketing, promotions and application-programming-interface license agreements. Under these contracts, we generally indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with claims by any third party with respect to our domain names, trademarks,

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logos and other branding elements to the extent that such marks are applicable to our performance under the subject agreement. In a limited number of agreements, including agreements under which we have developed technology for certain commercial parties, we have provided an indemnity for other types of third-party claims, substantially all of which are indemnities related to our copyrights, trademarks, and patents. In our PayPal business, we have provided an indemnity to our payments processors in the event of certain third-party claims or card association fines against the processor arising out of conduct by PayPal. To date, no significant costs have been incurred, either individually or collectively, in connection with our indemnification provisions.

Note 7 Stock-based Benefit Plans

Employee Stock Purchase Plan

We have an employee stock purchase plan for all eligible employees. Under the plan, shares of our common stock may be purchased over an offering period with a maximum duration of two years at 85% of the lower of the fair market value on the first day of the applicable offering period or on the last day of the six-month purchase period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. No shares were purchased during the three months ended March 31, 2005 or 2006. At March 31, 2006, approximately 7.2 million shares were authorized. Our employee stock purchase plan contains an evergreen provision that automatically increases, on each January 1, the number of shares reserved for issuance under the employee stock purchase plan by the number of shares purchased under this plan in the preceding calendar year.

Stock Unit Plan

We have a deferred stock unit plan under which deferred stock units have been granted to new non-employee directors elected to our Board of Directors after December 31, 2002. Under this plan, each new director receives a one-time grant of deferred stock units equal to the result of dividing $150,000 by the fair market value of our common stock on the date of grant. Each deferred stock unit constitutes an unfunded and unsecured promise by us to deliver one share of our common stock (or the equivalent value thereof in cash or property at our election). Each deferred stock unit award granted to a new non-employee director upon election to the Board vests 25% one year from the date of grant, and at a rate of 2.08% per month thereafter. If the services of the director are terminated at any time, all rights to the unvested deferred stock units shall also terminate. In addition, directors may elect to receive, in lieu of annual retainer and committee chair fees and at the time these fees would otherwise be payable (i.e., on a quarterly basis in arrears for services provided), fully vested deferred stock units with an initial value equal to the amount of these fees. Deferred stock units are payable following the termination of a director s tenure as a director. All eBay officers, directors and employees are eligible to receive awards under the plan, although, to date, awards have been made only to new non-employee directors. As of March 31, 2006, 29,224 units have been awarded under this plan.

Other Equity Incentive Plans

We have equity incentive plans for directors, officers, employees and non-employees. Stock options granted under these plans generally vest 25% one year from the date of grant (or 12.5% six months from the date of grant for grants to existing employees) and the remainder vest at a rate of 2.08% per month thereafter, and generally expire 7 to 10 years from the date of grant. Stock options issued prior to June 1998, were exercisable immediately, subject to repurchase rights held by us, which lapsed over the vesting period. At March 31, 2006, 584.8 million shares were authorized under our stock option plans. Shares of restricted stock issued under these plans are subject to repurchase rights which lapse over the vesting period, typically five years. At March 31, 2006, 74.2 million shares were available for future grant.

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Impact of the Adoption of FAS 123(R)

We adopted FAS 123(R) using the modified prospective transition method beginning January 1, 2006. Accordingly, during the three-month period ended March 31, 2006, we recorded stock-based compensation expense for awards granted prior to, but not yet vested, as of January 1, 2006, as if the fair value method required for pro forma disclosure under FAS 123 were in effect for expense recognition purposes, adjusted for estimated forfeitures. For these awards, we have continued to recognize compensation expense using the accelerated amortization method under FIN 28. For stock-based awards granted after January 1, 2006, we have recognized compensation expense based on the estimated grant date fair value method using the Black-Scholes valuation model. For these awards, we have recognized compensation expense using a straight-line amortization method. As FAS 123(R) requires that stock-based compensation expense be based on awards that are ultimately expected to vest, stock-based compensation for the three-month period ended March 31, 2006 has been reduced for estimated forfeitures. When estimating forfeitures, we consider voluntary termination behaviors as well as trends of actual option forfeitures. The impact on our results of operations of recording stock-based compensation for the three-month period ended March 31, 2006 was as follows (in thousands):

Cost of net revenues	$	9,476
Sales and marketing		24,721
Product development		20,701
General and administrative		28,920
	$	83,818

Prior to adopting FAS 123(R), we presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. FAS 123(R) requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. As a result of adopting FAS 123(R), $23.4 million of excess tax benefits for the three months ended March 31, 2006 have been classified as a financing cash inflow. Cash received from option exercises under all share-based payment arrangements for the three-month periods ended March 31, 2005 and 2006, was $179.3 million and $80.6 million, respectively. The total income tax benefit recognized in the income statement for stock-based compensation costs was $0 and $25.5 million for the three-month periods ended March 31, 2005 and 2006, respectively. Total stock-based compensation costs capitalized as part of an asset was $0 and $2.2 million for the three-month periods ended March 31, 2005 and 2006, respectively.

Prior to the adoption of FAS 123(R), the intrinsic value of Skype s and Shopping.com s unvested common stock options assumed in the acquisition were recorded as unearned stock-based compensation as of December 31, 2005. Upon the adoption of FAS 123(R) in January 2006, the unearned stock-based compensation balance of approximately $45.5 million was reclassified to additional-paid-in-capital.

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Valuation Assumptions

We calculated the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The following assumptions were used for each respective period:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2006
Risk-free interest rates	3.5%	4.6%-4.7%
Expected lives (in years)	3	3.1-4.9
Dividend yield	0%	0%
Expected volatility	36%	34%-38%
Weighted-average volatility		35%

Our computation of expected volatility for the first quarter of 2006 is based on a combination of historical and market-based implied volatility from traded options on our stock. Prior to 2006, our computation of expected volatility was based on historical volatility. Our computation of expected life in 2006, was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The range provided above results from the behavior patterns of separate groups of employees that have similar historical experience. The interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

Stock-based Payment Award Activity

The following table summarizes activity under our equity incentive plans for the three months ended March 31, 2006 (in thousands, except per share amounts):

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2006	129,109	$ 28.19		
Granted and assumed	21,064	40.14		
Exercised	(4,686)	17.20		
Forfeited/expired/cancelled	(1,983)	36.61		
Outstanding at March				