COMSCORE, INC.
Form S-1/A
May 25, 2007

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As filed with the Securities and Exchange Commission on May 25, 2007

Registration No. 333-141740

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Amendment No. 2
to
FORM S-1
REGISTRATION STATEMENT
Under
The Securities Act of 1933

COMSCORE, INC.
(Exact name of Registrant as specified in its charter)

Delaware	**7389**	**54-19555550**
(State or other jurisdiction of incorporation or organization)	*(Primary Standard Industrial Classification Code Number)*	*(I.R.S. Employer Identification Number)*

11465 Sunset Hills Road
Suite 200
Reston, Virginia 20190
(703) 438-2000
(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Magid M. Abraham, Ph.D.
President and Chief Executive Officer
comScore, Inc.
11465 Sunset Hills Road
Suite 200

Reston, Virginia 20190
(703) 438-2000
(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED MAY 25, 2007
PRELIMINARY PROSPECTUS

Shares

Common Stock

Prior to this offering, there has been no public market for our common stock. The initial public offering price of the common stock is expected to be between $ and $ per share. We have applied to list our common stock on The NASDAQ Global Market under the symbol SCOR.

We are selling shares of common stock and the selling stockholders are selling shares of common stock. We will not receive any of the proceeds from the shares of common stock sold by the selling stockholders.

The underwriters have an option to purchase a maximum of additional shares from us and the selling stockholders to cover over-allotments of shares. The underwriters can exercise this right at any time within 30 days from the date of this prospectus.

Investing in our common stock involves risks. See Risk Factors on page 9.

	Price to Public	**Underwriting Discounts and Commissions**	**Proceeds to comScore**	**Proceeds to Selling Stockholders**
Per Share	$	$	$	$
Total	$	$	$	$

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Delivery of the shares of common stock will be made on or about , 2007.

Credit Suisse **Deutsche Bank Securities**

William Blair & Company

Friedman Billings Ramsey

Jefferies & Company

The date of this prospectus is , 2007

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You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is different. This document may only be used where it is legal to sell these securities. The information in this document may only be accurate on the date of this document.

Dealer Prospectus Delivery Obligation

Until , 2007 (25 days after the commencement of this offering) all dealers that effect transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

comScore , Media Metrix and MyMetrix are registered trademarks in the U.S. and several other countries. Our unregistered trademarks and service marks include: Ad Metrix , Campaign R/F , Campaign Metrix , comScore Marketing Solutions , Marketing Solutions , Plan Metrix , qSearch , Video Metrix and World Metrix .

PROSPECTUS SUMMARY

This summary highlights information contained elsewhere in this prospectus. This summary does not contain all of the information you should consider before buying shares in this offering. Therefore, you should read this entire prospectus carefully, including the Risk Factors section beginning on page 8 and our consolidated financial statements and the related notes. Unless the context requires otherwise, the words we, us, our and comScore refer t comScore, Inc. and its consolidated subsidiaries.

comScore, Inc.

We provide a leading digital marketing intelligence platform that helps our customers make better-informed business decisions and implement more effective digital business strategies. Our products and solutions offer our customers deep insights into consumer behavior, including objective, detailed information regarding usage of their online properties and those of their competitors, coupled with information on consumer demographic characteristics, attitudes, lifestyles and offline behavior.

Our digital marketing intelligence platform is comprised of proprietary databases and a computational infrastructure that measures, analyzes and reports on digital activity. The foundation of our platform is data collected from our comScore panel of more than two million Internet users worldwide who have granted us explicit permission to confidentially measure their Internet usage patterns, online and certain offline buying behavior and other activities. By applying advanced statistical methodologies to our panel data, we project consumers online behavior for the total online population and a wide variety of user categories.

We deliver our digital marketing intelligence through our comScore Media Metrix product family and through comScore Marketing Solutions. Media Metrix delivers digital media intelligence by providing an independent, third-party measurement of the size, behavior and characteristics of Web site and online advertising network audiences among home, work and university Internet users as well as insights into the effectiveness of online advertising. Our Marketing Solutions products combine the proprietary information gathered from the comScore panel with the vertical industry expertise of comScore analysts to deliver digital marketing intelligence, including the measurement of online advertising effectiveness, customized for specific industries. We typically deliver our Media Metrix products electronically in the form of weekly, monthly or quarterly reports. Customers can access current and historical Media Metrix data and analyze these data anytime online. Our Marketing Solutions products are typically delivered on a monthly, quarterly or ad hoc basis through electronic reports and analyses.

In 2006, we generated revenues of $66.3 million and had cash flow from operations of $10.9 million. For the three months ended March 31, 2007, we generated revenues of $18.7 million and had cash flow from operations of $3.2 million. We derive our revenues primarily from the fees that we charge for subscription-based products and customized projects. A significant characteristic of our business model is our large percentage of subscription-based contracts. Subscription-based revenues have grown to 77% of our total revenues in the first quarter of 2007. See Management s Discussion and Analysis of Financial Condition and Results of Operations contained in this prospectus for a discussion of how we determine subscription-based revenues.

Our Industry

The Internet is a global digital medium for commerce, content, advertising and communications. According to International Data Corporation, or IDC, the number of global Internet users is projected to grow from approximately 968 million in 2005 to over 1.7 billion in 2010. As the online population continues to grow, the Internet is increasingly becoming a tool for research and commerce and for distributing and consuming media.

The interactive nature of digital media on the Internet enables businesses to access a wealth of user information that was virtually unavailable through offline audience measurement and marketing intelligence techniques. Digital media provide businesses with the opportunity to measure detailed user activity, such as how users interact with Web page content; to assess how users respond to online marketing, such as which online ads users click on to pursue a transaction; and to analyze how audiences and user behavior compare across various Web sites. This type of detailed user data can be combined with demographic, attitudinal and transactional information to develop a deeper understanding of user behavior, attributes and preferences.

We believe that the growth in the online and digital media markets for digital commerce, content, advertising and communications creates an unprecedented opportunity for businesses to acquire a deeper understanding of both their customers and their competitive market position. Businesses can use accurate, relevant and objective digital marketing intelligence to develop and validate key strategies and improve performance.

The comScore Digital Marketing Intelligence Platform

We provide a leading digital marketing intelligence platform that enables our customers to devise and implement more effective digital business strategies.

Key attributes of our platform include:

Panel of global Internet users. Our ability to provide digital marketing intelligence is based on information continuously gathered from a broad cross-section of more than two million Internet users worldwide who have granted us explicit permission to confidentially measure their Internet usage patterns, online and certain offline buying behavior and other activities.

Scalable technology infrastructure. We developed our databases and computational infrastructure to support the growth in online activity among our global Internet panel and the increasing complexity of digital content formats, advertising channels and communication applications. The design of our technology infrastructure is based on distributed processing and data capture environments that allow for the collection and organization of vast amounts of data on online activity.

Benefits of our platform include:

Advanced digital marketing intelligence. We use our proprietary technology to compile vast amounts of data on Internet user activity and to organize that data into discrete, measurable elements that can be used to provide actionable insights to our customers.

Objective third-party resource for digital marketing intelligence. We are an independent company that is not affiliated with the digital businesses we measure and analyze, allowing us to serve as an objective third-party provider of digital marketing intelligence.

Vertical industry expertise. We have developed expertise across a variety of industries to provide digital marketing intelligence specifically tailored to the needs of our customers operating in specific industry sectors. We have dedicated personnel to address the automotive, consumer packaged goods, entertainment, financial services, media, pharmaceutical, retail, technology, telecommunications and travel industries.

Ease of use and functionality. The comScore digital marketing intelligence platform is designed to be easy to use by our customers. Our products are primarily available through the Internet using a standard browser; our customers do not need to install additional hardware or software to access our products.

Our Strategy

Our objective is to be the leading provider of global digital marketing intelligence products. We plan to pursue our objective through internal initiatives and, potentially, through acquisitions and other investments. The principal elements of our strategy are to:

- deepen relationships with current customers;
- grow our customer base;
- expand our digital marketing intelligence platform;

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address emerging digital media;

extend technology leadership;

build brand awareness through media exposure; and

grow internationally.

Risks Related to Our Business

Our business is subject to a number of risks that you should be aware of before making an investment decision. These risks are discussed more fully in the section entitled Risk Factors immediately following this prospectus summary. We have a limited operating history, and we must continue to retain and attract customers. We must be able to maintain an Internet user panel of sufficient size in order to provide the quality of marketing intelligence demanded by our customers. Although we were profitable in each quarter of 2006 and the first quarter of 2007, we were not profitable in 2005, and we had, at March 31, 2007, an accumulated deficit of $98.6 million.

Company Information

We incorporated in August 1999 in Delaware. Our principal offices are located at 11465 Sunset Hills Road, Suite 200, Reston, Virginia 20190. Our telephone number is (703) 438-2000. You can access our Web site at www.comscore.com. Information contained on our Web site is not part of this prospectus and is not incorporated in this prospectus by reference.

comScore, Media Metrix and MyMetrix are registered trademarks in the U.S. and several other countries. Our unregistered trademarks and service marks include: Ad Metrix, Campaign R/F, Campaign Metrix, comScore Marketing Solutions, Marketing Solutions, Plan Metrix, qSearch, Video Metrix and World Metrix.

The Offering

Common stock offered by us	shares
Common stock offered by the selling stockholders	shares
Total common stock offered	shares
Common stock outstanding after this offering	shares
Use of proceeds	We intend to use the net proceeds from this offering for working capital, for capital expenditures and for other general corporate purposes. We may also use a portion of our net proceeds to fund potential acquisitions. We will not receive any proceeds from the sale of shares of our common stock by the selling stockholders. See Use of Proceeds.
Proposed NASDAQ Global Market symbol	SCOR
Risk factors	See Risk Factors and other information included in this prospectus for a discussion of factors you should carefully consider before deciding to invest in shares of our common stock.

The number of shares of common stock that will be outstanding after this offering is based on the number of shares outstanding as of March 31, 2007 and assumes the conversion of our preferred stock into an aggregate of 86,286,697 shares of our common stock. This number excludes:

12,486,511 shares of common stock issuable upon exercise of options outstanding at a weighted-average exercise price of $0.41 per share;

264,250 shares of our common stock issuable upon the settlement of outstanding restricted stock unit awards;

2,295,125 shares of common stock reserved for future issuance under our 1999 Stock Plan;

7,000,000 shares of common stock reserved for future issuance under our 2007 Equity Incentive Plan, which will be effective upon completion of this offering; and

875,923 shares of common stock issuable upon the exercise of warrants, which total includes warrants for our preferred stock that will become exercisable for common stock after this offering, at a weighted-average exercise price of $0.97 per share.

Unless otherwise indicated, all information in this prospectus assumes:

a -for- reverse split of our common stock that will occur prior to the consummation of this offering;

the conversion, in accordance with our certificate of incorporation, of all our shares of outstanding preferred stock into an aggregate of 86,286,697 shares of our common stock;

no exercise by the underwriters of their option to purchase up to additional shares to cover over-allotments, consisting of shares to be purchased from us and shares to be purchased from the selling stockholders; and

the adoption of our amended and restated certificate of incorporation and bylaws that will occur immediately prior to the consummation of this offering.

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Summary Historical Financial Data

You should read the summary historical financial data set forth below in conjunction with our consolidated financial statements, the notes to our consolidated financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations contained elsewhere in this prospectus. The consolidated statements of operations data and the consolidated statements of cash flows data for each of the three years ended December 31, 2004, 2005 and 2006 as well as the consolidated balance sheet data as of December 31, 2005 and 2006 are derived from our audited consolidated financial statements that are included elsewhere in this prospectus. The consolidated statements of operations data for the three months ended March 31, 2006 and 2007 and the consolidated balance sheet data as of March 31, 2007 have been derived from our unaudited consolidated financial statements that are included elsewhere in this prospectus. We have prepared this unaudited financial information on the same basis as the audited consolidated financial statements and have included all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of our financial position and operating results for such period. Our historical results are not necessarily indicative of results to be expected for future periods. Results for the three months ended March 31, 2007 are not necessarily indicative of results expected for the full year.

	Year Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
			(In thousands)		
Consolidated Statement of Operations Data:					
Revenues	$ 34,894	$ 50,267	$ 66,293	$ 14,985	$ 18,681
Cost of revenues(1)	13,153	18,218	20,560	5,148	5,388
Selling and marketing(1)	13,890	18,953	21,473	5,345	6,451
Research and development(1)	5,493	7,416	9,009	2,137	2,556
General and administrative(1)	4,982	7,089	8,293	1,918	2,507
Amortization	356	2,437	1,371	371	293
Total expenses from operations	37,874	54,113	60,706	14,919	17,195
(Loss) income from operations	(2,980)	(3,846)	5,587	66	1,486
Interest (expense) income, net	(246)	(208)	231	11	97
(Loss) gain from foreign currency		(96)	125	6	(8)
Revaluation of preferred stock warrant liabilities		(14)	(224)	2	11
(Loss) income before income taxes and cumulative effect of change in accounting principle	(3,226)	(4,164)	5,719	85	1,586
(Benefit) provision for income taxes		(182)	50		46
Net (loss) income before cumulative effect of change in accounting principle	(3,226)	(3,982)	5,669	85	1,540
Cumulative effect of change in accounting principle		(440)			

Net (loss) income		(3,226)		(4,422)		5,669		85		1,540
Accretion of redeemable preferred stock		(2,141)		(2,638)		(3,179)		(742)		(885)
Net (loss) income attributable to common stockholders	$	(5,367)	$	(7,060)	$	2,490	$	(657)	$	655

(1) Amortization of stock-based compensation is included in the line items above as follows:

	Year Ended December 31,						Three Months Ended March 31,			
	2004		2005		2006		2006		2007	
							(Unaudited)			
	(In thousands)									
Cost of revenues	$		$		$	12	$		$	9
Selling and marketing						82		6		39
Research and development						13				8
General and administrative		14		3		91		1		51

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The following table presents consolidated balance sheet data as of March 31, 2007:

on an actual basis without any adjustments to reflect subsequent or anticipated events;

on a pro forma basis reflecting (i) the conversion of all outstanding shares of our Series A, Series B, Series C, Series C-1, Series D and Series E preferred stock into an aggregate of 86,286,697 shares of our common stock effective immediately prior to the completion of this offering, for a total of 111,915,643 shares of common stock, which amount includes 1,738,172 shares subject to put and (ii) the reclassification of our preferred stock warrant liabilities from current liabilities to additional paid in capital effective upon the completion of this offering; and

on a pro forma as adjusted basis reflecting the conversion and reclassification described above and the receipt by us of the net proceeds from the sale of shares of common stock in this offering at an assumed initial public offering price of $ per share, after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

	As of March 31, 2007		
	Actual	Pro Forma	Pro Forma as Adjusted
		(Unaudited) (In thousands)	
Consolidated Balance Sheet Data:			
Cash, cash equivalents and short-term investments	$ 18,181	$ 18,181	
Total current assets	34,520	34,520	
Total assets	45,479	45,479	
Total current liabilities	34,897	33,902	
Capital lease obligations, long-term	1,896	1,896	
Common stock subject to put	4,392	4,392	
Redeemable preferred stock	102,580		
Stockholders equity (deficit)	(98,683)	4,892	

	Year Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
			(In thousands)		
Consolidated Statement of Cash Flows Data:					
Net cash provided by operating activities	$ 1,907	$ 4,253	$ 10,905	$ 2,824	$ 3,156
Depreciation and amortization	2,745	5,123	4,259	1,059	1,154
Capital expenditures	1,208	1,071	2,314	292	494

	Year Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
	(In thousands)				
Other Financial and Operating Data (unaudited):					
Adjusted EBITDA(2)	$ (221)	$ 730	$ 9,945	$ 1,140	$ 2,750

(2) We define Adjusted EBITDA as net income plus the (benefit) provision for income taxes, depreciation, amortization of purchased intangible assets and stock-based compensation; plus interest expense (income) and other income. Adjusted EBITDA is not a measure of liquidity calculated in accordance with GAAP, and should be viewed as a supplement to not a substitute for our results of operations presented on the basis of GAAP. Adjusted EBITDA does not purport to represent cash flow provided by, or used in, operating activities as defined by GAAP. Our statement of cash flows presents our cash flow activity in accordance with GAAP. Furthermore, Adjusted EBITDA is not necessarily comparable to similarly-titled measures reported by other companies.

We prepare Adjusted EBITDA to eliminate the impact of items that we do not consider indicative of our core operating performance. You are encouraged to evaluate these adjustments and the reasons we consider them appropriate for supplemental analysis. Our presentation of Adjusted EBITDA should not be construed as an implication that our future results will be unaffected by unusual or non-recurring items.

We believe Adjusted EBITDA is useful to an investor in evaluating our operating performance for the following reasons:

Adjusted EBITDA is widely used by investors to measure a company s operating performance without regard to items such as interest expense, taxes, depreciation and amortization, and stock-based compensation, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which assets were acquired;

analysts and investors use Adjusted EBITDA as a supplemental measure to evaluate the overall operating performance of companies in our industry;

we believe Adjusted EBITDA is an important indicator of our operational strength and the performance of our business because it provides a link between profitability and operating cash flow. Although our cash flow from operations presented is a similar measure, Adjusted EBITDA is a better measure of our true operating results because it adjusts for the effects of collections of receivables, disbursements of payables, and other factors that are influenced by seasonal conditions; and

prior to January 1, 2006, we accounted for stock-based compensation plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation.* In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which is a revision of SFAS No. 123. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated fair values. Pro forma disclosure is no longer an alternative permitted under SFAS 123R. We adopted the provisions of SFAS 123R on January 1, 2006, using the prospective method. Unvested stock-based awards issued to employees prior to January 1, 2006, the date that we adopted the provisions of SFAS 123R, were accounted for at the date of adoption using the intrinsic value method originally applied to those awards. We recorded approximately $198,000 in stock-based compensation expense subsequent to the adoption of SFAS 123R for the fiscal year ended December 31, 2006 as compared with approximately $14,000 and $3,000 for the years ended December 31, 2004 and 2005, respectively, prior to the adoption of SFAS 123R. By comparing our Adjusted EBITDA our investors can evaluate our operating results without the additional variations of stock compensation expense, which is not necessarily

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comparable from year to year due to the change in accounting treatment and is a non-cash expense that is not a primary measure of our operations.

Our management uses Adjusted EBITDA:

as a measure of operating performance, because it does not include the impact of items not directly resulting from our core operations;

for planning purposes, including the preparation of our annual operating budget;

to allocate resources to enhance the financial performance of our business;

as a metric for evaluating the performance of Dr. Magid M. Abraham, our Chief Executive Officer, and Mr. Gian M. Fulgoni, our Executive Chairman of the Board of Directors. The Company uses Adjusted EBITDA as a quantitative metric for setting both Dr. Abraham and Mr. Fulgoni s respective salaries and bonuses. In addition, option grants held by both Dr. Abraham and Mr. Fulgoni include vesting which can be accelerated upon achieving certain targets tied to EBITDA;

to evaluate the effectiveness of our business strategies; and

in communications with our board of directors, stockholders, analysts and investors concerning our financial performance.

We understand that although Adjusted EBITDA is frequently used by securities analysts, lenders and others in their evaluation of companies, Adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of, our results of operations as reported under GAAP. Some of these limitations are:

Adjusted EBITDA does not reflect our cash expenditures or future requirements for capital expenditures or other contractual commitments;

Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

Adjusted EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, related to our debts;

Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements; and

Other companies in our industry may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

A reconciliation of Adjusted EBITDA to net income, the most directly comparable GAAP measure, for each of the fiscal periods indicated is as follows:

	Three Months Ended

	Year Ended December 31,			March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
			(In thousands)		
Net (loss) income	$ (3,226)	$ (4,422)	$ 5,669	$ 85	$ 1,540
(Benefit) provision for income taxes		(182)	50		46
Amortization	356	2,437	1,371	371	293
Depreciation	2,389	2,686	2,888	688	861
Stock-based compensation	14	3	198	7	107
Interest expense (income), net	246	208	(231)	(11)	(97)
Adjusted EBITDA	$ (221)	$ 730	$ 9,945	$ 1,140	$ 2,750

RISK FACTORS

An investment in our common stock offered by this prospectus involves a substantial risk of loss. You should carefully consider these risk factors, together with all of the other information included in this prospectus, before you decide to purchase shares of our common stock. The occurrence of any of the following risks could materially adversely affect our business, financial condition or operating results. In that case, the trading price of our common stock could decline, and you may lose part or all of your investment.

Risks Related to Our Business and Our Technologies

If we are not able to maintain a panel of sufficient size and scope, or if the costs of maintaining our panel materially increase, our business would be harmed.

We believe that the quality, size and scope of our Internet user panel are critical to our business. There can be no assurance, however, that we will be able to maintain a panel of sufficient size and scope to provide the quality of marketing intelligence that our customers demand from our products. If we fail to maintain a panel of sufficient size and scope, customers might decline to purchase our products or renew their subscriptions, our reputation could be damaged and our business could be materially and adversely affected. We expect that our panel costs may increase and may comprise a greater portion of our cost of revenues in the future. The costs associated with maintaining and improving the quality, size and scope of our panel are dependent on many factors, many of which are beyond our control, including the participation rate of potential panel members, the turnover among existing panel members and requirements for active participation of panel members, such as completing survey questionnaires. Concerns over the potential unauthorized disclosure of personal information or the classification of our software as spyware or adware may cause existing panel members to uninstall our software or may discourage potential panel members from installing our software. To the extent we experience greater turnover, or churn, in our panel than we have historically experienced, these costs would increase more rapidly. In addition, publishing content on the Internet and purchasing advertising space on Web sites may become more expensive or restrictive in the future, which could decrease the availability and increase the cost of advertising the incentives we offer to panel members. To the extent that such additional expenses are not accompanied by increased revenues, our operating margins would be reduced and our financial results would be adversely affected.

Our quarterly results of operations may fluctuate in the future. As a result, we may fail to meet or exceed the expectations of securities analysts or investors, which could cause our stock price to decline.

Our quarterly results of operations may fluctuate as a result of a variety of factors, many of which are outside of our control. If our quarterly revenues or results of operations do not meet or exceed the expectations of securities analysts or investors, the price of our common stock could decline substantially. In addition to the other risk factors set forth in this Risk Factors section, factors that may cause fluctuations in our quarterly revenues or results of operations include:

- our ability to increase sales to existing customers and attract new customers;
- our failure to accurately estimate or control costs;
- our revenue recognition policies related to the timing of contract renewals, delivery of products and duration of contracts and the corresponding timing of revenue recognition;
- the mix of subscription-based versus project-based revenues;

the impact on our contract renewal rates, in particular for our subscription-based products, caused by our customers budgetary constraints, competition, customer dissatisfaction or our customers actual or perceived lack of need for our products;

the potential loss of significant customers;

the effect of revenues generated from significant one-time projects;

the amount and timing of capital expenditures and operating costs related to the maintenance and expansion of our operations and infrastructure;

the timing and success of new product introductions by us or our competitors;

- variations in the demand for our products and the implementation cycles of our products by our customers;
- changes in our pricing and discounting policies or those of our competitors;
- service outages, other technical difficulties or security breaches;
- limitations relating to the capacity of our networks, systems and processes;
- maintaining appropriate staffing levels and capabilities relative to projected growth;
- adverse judgments or settlements in legal disputes;
- the timing of costs related to the development or acquisition of technologies, services or businesses to support our existing customer base and potential growth opportunities; and
- general economic, industry and market conditions and those conditions specific to Internet usage and online businesses.

We believe that our quarterly revenues and results of operations on a year-over-year and sequential quarter-over-quarter basis may vary significantly in the future and that period-to-period comparisons of our operating results may not be meaningful. You should not rely on the results of prior quarters as an indication of future performance.

The market for digital marketing intelligence is at an early stage of development, and if it does not develop, or develops more slowly than expected, our business will be harmed.

The market for digital marketing intelligence products is at a relatively early stage of development, and it is uncertain whether these products will achieve high levels of demand and increased market acceptance. Our success will depend to a substantial extent on the willingness of companies to increase their use of such products. Factors that may affect market acceptance include:

- the reliability of digital marketing intelligence products;
- public concern regarding privacy and data security;
- decisions of our customers and potential customers to develop digital marketing intelligence capabilities internally rather than purchasing such products from third-party suppliers like us;
- decisions by industry associations in the United States or in other countries that result in association-directed awards, on behalf of their members, of digital measurement contracts to one or a limited number of competitive vendors;
- the ability to maintain high levels of customer satisfaction; and
- the rate of growth in eCommerce, online advertising and digital media.

The market for our products may not develop further, or may develop more slowly than we expect, either of which could adversely affect our business and operating results.

We have a limited operating history and may not be able to achieve financial or operational success.

We were incorporated in 1999 and introduced our first syndicated Internet audience measurement product in 2000. Many of our other products were first introduced during the past few years. Accordingly, we are still in the early stages of development and have only a limited operating history upon which our business can be evaluated. You should evaluate our likelihood of financial and operational success in light of the risks, uncertainties, expenses, delays and difficulties associated with an early-stage business in an evolving market, some of which may be beyond our control, including:

- our ability to successfully manage any growth we may achieve in the future;
- the risks associated with operating a business in international markets, including China; and
- our ability to successfully integrate acquired businesses, technologies or services.

We have a history of significant net losses, may incur significant net losses in the future and may not maintain profitability.

We have incurred significant losses in recent periods, including net losses of $3.2 million and $4.4 million in 2004 and 2005, respectively. Although we achieved net income of $5.7 million in 2006 and $1.5 million for the three months ended March 31, 2007, we cannot assure you that we will continue to sustain or increase profitability in the future. As of March 31, 2007, we had an accumulated deficit of $98.6 million. Because a large portion of our costs are fixed, we may not be able to reduce or maintain our expenses in response to any decrease in our revenues, which would adversely affect our operating results. In addition, we expect operating expenses to increase as we implement certain growth initiatives, which include, among other things, the development of new products, expansion of our infrastructure, plans for international expansion and general and administrative expenses associated with being a public company. If our revenues do not increase to offset these expected increases in costs and operating expenses, our operating results would be materially and adversely affected. You should not consider our revenue growth in recent periods as indicative of our future performance, as our operating results for future periods are subject to numerous uncertainties.

Material defects or errors in our data collection and analysis systems could damage our reputation, result in significant costs to us and impair our ability to sell our products.

Our data collection and analysis systems are complex and may contain material defects or errors. In addition, the large amount of data that we collect may cause errors in our data collection and analysis systems. Any defect in our panelist data collection software, network systems, statistical projections or other methodologies could result in:

- loss of customers;
- damage to our brand;
- lost or delayed market acceptance and sales of our products;
- interruptions in the availability of our products;
- the incurrence of substantial costs to correct any material defect or error;
- sales credits, refunds or liability to our customers;
- diversion of development resources; and
- increased warranty and insurance costs.

Any material defect or error in our data collection systems could adversely affect our reputation and operating results.

Our business may be harmed if we deliver, or are perceived to deliver, inaccurate information to our customers or to the media.

If the information that we provide to our customers or the media is inaccurate, or perceived to be inaccurate, our brand may be harmed. The information that we collect or that is included in our databases and the statistical projections that we provide to our customers may contain inaccuracies. Any dissatisfaction by our customers or the media with our digital marketing intelligence, measurement or data collection and statistical projection methodologies could have an adverse effect on our ability to retain existing customers and attract new customers and could harm our brand. Additionally, we could be contractually required to pay damages, which could be substantial, to certain of our customers if the information we provide to them is found to be inaccurate. Any liability that we incur or any harm to our brand that we suffer because of actual or perceived irregularities or inaccuracies in the data we deliver to our customers could harm our business.

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Our business may be harmed if we change our methodologies or the scope of information we collect.

We have in the past and may in the future change our methodologies or the scope of information we collect. Such changes may result from identified deficiencies in current methodologies, development of more advanced methodologies, changes in our business plans or expressed or perceived needs of our customers or potential customers. Any such changes or perceived changes, or our inability to accurately or adequately communicate to our customers and the media such changes and the potential implications of such changes on the data we have published or will publish in the future, may result in customer dissatisfaction, particularly if certain information is no longer collected or information collected in future periods is not comparable with information collected in prior periods. For example, in 2002, we integrated our existing methodologies with those of Jupiter Media Metrix, which we had recently acquired. As part of this process, we discontinued reporting certain metrics. Some customers were dissatisfied and either terminated their subscriptions or failed to renew their subscriptions because of these changes. Future changes to our methodologies or the information we collect may cause similar customer dissatisfaction and result in loss of customers.

We may lose customers or be liable to certain customers if we provide poor service or if our products do not comply with our customer agreements.

Errors in our systems resulting from the large amount of data that we collect, store and manage could cause the information that we collect to be incomplete or to contain inaccuracies that our customers regard as significant. The failure or inability of our systems, networks and processes to adequately handle the data in a high quality and consistent manner could result in the loss of customers. In addition, we may be liable to certain of our customers for damages they may incur resulting from these events, such as loss of business, loss of future revenues, breach of contract or loss of goodwill to their business.

Our insurance policies may not cover any claim against us for loss of data, inaccuracies in data or other indirect or consequential damages and defending a lawsuit, regardless of its merit, could be costly and divert management s attention. Adequate insurance coverage may not be available in the future on acceptable terms, or at all. Any such developments could adversely affect our business and results of operations.

The market for digital marketing intelligence is highly competitive, and if we cannot compete effectively, our revenues will decline and our business will be harmed.

The market for digital marketing intelligence is highly competitive and is evolving rapidly. We compete primarily with providers of digital media intelligence and related analytical products and services. We also compete with providers of marketing services and solutions, with full-service survey providers and with internal solutions developed by customers and potential customers. Our principal competitors include:

- large and small companies that provide data and analysis of consumers online behavior, including Compete Inc., Hitwise Pty. Ltd and NetRatings, Inc.;

- online advertising companies that provide measurement of online ad effectiveness, including aQuantive, Inc., DoubleClick Inc., ValueClick, Inc. and WPP Group plc;

- companies that provide audience ratings for TV, radio and other media that have extended or may extend their current services, particularly in certain international markets, to the measurement of digital media, including Arbitron Inc., Nielsen Media Research, Inc. and Taylor Nelson Sofres plc;

analytical services companies that provide customers with detailed information of behavior on their own Web sites, including Omniture, Inc., WebSideStory, Inc. and WebTrends Corporation;

full-service market research firms and survey providers that may measure online behavior and attitudes, including Harris Interactive Inc., Ipsos Group, Taylor Nelson Sofres plc and The Nielsen Company; and

specialty information providers for certain industries that we serve, including IMS Health Incorporated (healthcare) and Telephia, Inc. (telecommunications).

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Some of our current competitors have longer operating histories, access to larger customer bases and substantially greater resources than we do. As a result, these competitors may be able to devote greater resources to marketing and promotional campaigns, panel retention, panel development or development of systems and technologies than we can. In addition, some of our competitors may adopt more aggressive pricing policies. Furthermore, large software companies, Internet portals and database management companies may enter our market or enhance their current offerings, either by developing competing services or by acquiring our competitors, and could leverage their significant resources and pre-existing relationships with our current and potential customers.

If we are unable to compete successfully against our current and future competitors, we may not be able to retain and acquire customers, and we may consequently experience a decline in revenues, reduced operating margins, loss of market share and diminished value from our products.

Concern over spyware and privacy, including any violations of privacy laws or perceived misuse of personal information, could cause public relations problems and could impair our ability to recruit panelists or maintain a panel of sufficient size and scope, which in turn could adversely affect our ability to provide our products.

Any perception of our practices as an invasion of privacy, whether legal or illegal, may subject us to public criticism. Existing and future privacy laws and increasing sensitivity of consumers to unauthorized disclosures and use of personal information may create negative public reaction related to our business practices. Public concern has increased recently regarding certain kinds of downloadable software known as spyware and adware. These concerns might cause users to refrain from downloading software from the Internet, including our proprietary technology, which could make it difficult to recruit additional panelists or maintain a panel of sufficient size and scope to provide meaningful marketing intelligence. In response to spyware and adware concerns, numerous programs are available, many of which are available for free, that claim to identify and remove spyware and adware from users computers. Some of these anti-spyware programs have in the past identified, and may in the future identify, our software as spyware or as a potential spyware application. We actively seek to prevent the inclusion of our software on lists of spyware applications or potential spyware applications, to apply best industry practices for obtaining appropriate consent from panelists and protecting the privacy and confidentiality of our panelist data and to comply with existing privacy laws. However, to the extent that we are not successful, or to the extent that new anti-spyware programs classify our software as spyware or as a potential spyware application, our brand may be harmed and users of these programs may uninstall our software. Any resulting reputational harm or decrease in the size or scope of our panel could reduce the demand for our products, increase the cost of recruiting panelists and adversely affect our ability to provide our products to our customers. Any of these effects could harm our business.

Any unauthorized disclosure or theft of private information we gather could harm our business.

Unauthorized disclosure of personally identifiable information regarding Web site visitors, whether through breach of our secure network by an unauthorized party, employee theft or misuse, or otherwise, could harm our business. If there were an inadvertent disclosure of personally identifiable information, or if a third party were to gain unauthorized access to the personally identifiable information we possess, our operations could be seriously disrupted and we could be subject to claims or litigation arising from damages suffered by panel members or pursuant to the agreements with our customers. In addition, we could incur significant costs in complying with the multitude of state, federal and foreign laws regarding the unauthorized disclosure of personal information. For example, California law requires companies that maintain data on California residents to inform individuals of any security breaches that result in their personal information being stolen. Finally, any perceived or actual unauthorized disclosure of the information we collect could harm our reputation, substantially impair our ability to attract and retain panelists and have an adverse impact on our business.

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We may encounter difficulties managing our growth, which could adversely affect our results of operations.

We have experienced significant growth in recent periods. We have substantially expanded our overall business, customer base, headcount, data collection and processing infrastructure and operating procedures as our business has grown. We increased our total number of full time employees from 176 employees as of December 31, 2003 to 386 employees as of March 31, 2007, and we expect to continue to expand our workforce to meet our strategic objectives. In addition, during this same period, we made substantial investments in our network infrastructure operations as a result of our growth. We believe that we will need to continue to effectively manage and expand our organization, operations and facilities in order to accommodate our expected future growth. If we continue to grow, our current systems and facilities may not be adequate. Our need to effectively manage our operations and growth requires that we continue to assess and improve our operational, financial and management controls, reporting systems and procedures. If we are not able to efficiently and effectively manage our growth, our business may be impaired.

If the Internet advertising and eCommerce markets develop slower than we expect, our business will suffer.

Our future success will depend on continued growth in the use of the Internet as an advertising medium, a continued increase in eCommerce spending and the proliferation of the Internet as a platform for a wide variety of consumer activities. These markets are evolving rapidly, and it is not certain that their current growth trends will continue.

The adoption of Internet advertising, particularly by advertisers that have historically relied on traditional offline media, requires the acceptance of new approaches to conducting business. Advertisers may perceive Internet advertising to be less effective than traditional advertising for marketing their products. They may also be unwilling to pay premium rates for online advertising that is targeted at specific segments of users based on their demographic profile or Internet behavior. The online advertising and eCommerce markets may also be adversely affected by privacy issues relating to such targeted advertising, including that which makes use of personalized information. Furthermore, online merchants may not be able to establish online commerce models that are cost effective and may not learn how to effectively compete with other Web sites or offline merchants. In addition, consumers may not continue to shift their spending on goods and services from offline outlets to the Internet. As a result, growth in the use of the Internet for eCommerce may not continue at a rapid rate, or the Internet may not be adopted as a medium of commerce by a broad base of customers or companies worldwide. Because of the foregoing factors, among others, the market for Internet advertising and eCommerce may not continue to grow at significant rates. If these markets do not continue to develop, or if they develop slower than expected, our business will suffer.

Our growth depends upon our ability to retain existing large customers and add new large customers; however, to the extent we are successful in doing so, our ability to maintain profitability and positive cash flow may be impaired.

Our success depends in part on our ability to sell our products to large customers and on the renewal of the subscriptions of those customers in subsequent years. For the years ended December 31, 2004, 2005 and 2006 and the three months ended March 31, 2007, we derived over 38%, 41%, 39% and 39%, respectively, of our total revenues from our top 10 customers. The loss of any one or more of those customers could decrease our revenues and harm our current and future operating results. The addition of new large customers or increases in sales to existing large customers may require particularly long implementation periods and other costs, which may adversely affect our profitability. To compete effectively, we have in the past been, and may in the future be, forced to offer significant discounts to maintain existing customers or acquire other large customers. In addition, we may be forced to reduce or withdraw from our relationships with certain existing customers or refrain from acquiring certain new customers in order to acquire or maintain relationships with important large customers. As a result, new large customers or increased usage of our products by large customers may cause our profits to decline and our ability to sell our products to other customers could be adversely affected.

We derive a significant portion of our revenues from a single customer, Microsoft Corporation. For the years ended December 31, 2004, 2005 and 2006 and the three months ended March 31, 2007, we derived approximately 5%, 14%, 12% and 12%, respectively, of our total revenues from Microsoft. If Microsoft were to cease or substantially reduce its use of our products, our revenues and earnings might decline.

If we fail to develop our brand, our business may suffer.

We believe that building and maintaining awareness of comScore and our portfolio of products in a cost-effective manner is critical to achieving widespread acceptance of our current and future products and is an important element in attracting new customers. We rely on our relationships with the media and the exposure we receive from numerous citations of our data by media outlets to build brand awareness and credibility among our customers and the marketplace. Furthermore, we believe that brand recognition will become more important for us as competition in our market increases. Our brand s success will depend on the effectiveness of our marketing efforts and on our ability to provide reliable and valuable products to our customers at competitive prices. Our brand marketing activities may not yield increased revenues, and even if they do, any increased revenues may not offset the expenses we incur in attempting to build our brand. If we fail to successfully market our brand, we may fail to attract new customers, retain existing customers or attract media coverage to the extent necessary to realize a sufficient return on our brand-building efforts, and our business and results of operations could suffer.

Failure to effectively expand our sales and marketing capabilities could harm our ability to increase our customer base and achieve broader market acceptance of our products.

Increasing our customer base and achieving broader market acceptance of our products will depend to a significant extent on our ability to expand our sales and marketing operations. We expect to continue to rely on our direct sales force to obtain new customers. We plan to continue to expand our direct sales force both domestically and internationally. We believe that there is significant competition for direct sales personnel with the sales skills and technical knowledge that we require. Our ability to achieve significant growth in revenues in the future will depend, in large part, on our success in recruiting, training and retaining sufficient numbers of direct sales personnel. In general, new hires require significant training and substantial experience before becoming productive. Our recent hires and planned hires may not become as productive as we require, and we may be unable to hire or retain sufficient numbers of qualified individuals in the future in the markets where we currently operate or where we seek to conduct business. Our business will be seriously harmed if the efforts to expand our sales and marketing capabilities are not successful or if they do not generate a sufficient increase in revenues.

We have limited experience with respect to our pricing model, and if the prices we charge for our products are unacceptable to our customers, our revenues and operating results will be harmed.

We have limited experience in determining the prices for our products that our existing and potential customers will find acceptable. As the market for our products matures, or as new competitors introduce new products or services that compete with ours, we may be unable to renew our agreements with existing customers or attract new customers at the prices we have historically charged. As a result, it is possible that future competitive dynamics in our market may require us to reduce our prices, which could have an adverse effect on our revenues, profitability and operating results.

We derive a significant portion of our revenues from sales of our subscription-based digital marketing intelligence products. If our customers terminate or fail to renew their subscriptions, our business could suffer.

We currently derive a significant portion of our revenues from our subscription-based digital marketing intelligence products. Subscription-based products accounted for 70%, 75% and 77% of our revenues in 2005, 2006 and the first quarter of 2007, respectively. However, if our customers terminate their subscriptions for our products, do not renew their subscriptions, delay renewals of their subscriptions or renew on terms less favorable to us, our revenues could decline and our business could suffer.

Our customers have no obligation to renew after the expiration of their initial subscription period, which is typically one year, and we cannot assure you that current subscriptions will be renewed at the same or higher price levels, if at all. Some of our customers have elected not to renew their subscription agreements with us in the past. If we experience a change of control, as defined in such agreements, some of our customers have the right to terminate their subscriptions. Moreover, some of our major customers have the right to cancel their subscription agreements without cause at any time. We have limited historical data with respect to rates of customer subscription renewals, so we cannot accurately predict future customer renewal rates. Our customer renewal rates may decline or fluctuate as a result of a number of factors, including customer satisfaction or dissatisfaction with our products, the prices or functionality of our products, the prices or functionality of products offered by our competitors, mergers and acquisitions affecting our customer base or reductions in our customers spending levels.

If we are unable to sell additional products to our existing customers or attract new customers, our revenue growth will be adversely affected.

To increase our revenues, we believe we must sell additional products to existing customers and regularly add new customers. If our existing and prospective customers do not perceive our products to be of sufficient value and quality, we may not be able to increase sales to existing customers and attract new customers, and our operating results will be adversely affected.

We depend on third parties for data that is critical to our business, and our business could suffer if we cannot continue to obtain data from these suppliers.

We rely on third-party data sources for information regarding certain offline activities of our panelists. The availability and accuracy of these data is important to the continuation and development of our products that link online activity to offline purchases. If this information is not available to us at commercially reasonable terms, or is found to be inaccurate, it could harm our reputation, business and financial performance.

System failures or delays in the operation of our computer and communications systems may harm our business.

Our success depends on the efficient and uninterrupted operation of our computer and communications systems and the third-party data centers we use. Our ability to collect and report accurate data may be interrupted by a number of factors, including our inability to access the Internet, the failure of our network or software systems, computer viruses, security breaches or variability in user traffic on customer Web sites. A failure of our network or data gathering procedures could impede the processing of data, cause the corruption or loss of data or prevent the timely delivery of our products.

In the future, we may need to expand our network and systems at a more rapid pace than we have in the past. Our network or systems may not be capable of meeting the demand for increased capacity, or we may incur additional unanticipated expenses to accommodate these capacity demands. In addition, we may lose valuable data, be unable to obtain or provide data on a timely basis or our network may temporarily shut down if we fail to adequately expand or maintain our network capabilities to meet future requirements. Any lapse in our ability to collect or transmit data may decrease the value of our products and prevent us from providing the data requested by our customers. Any disruption in our network processing or loss of Internet user data may damage our reputation and result in the loss of customers, and our business and results of operations could be adversely affected.

We rely on a small number of third-party service providers to host and deliver our products, and any interruptions or delays in services from these third parties could impair the delivery of our products and harm our business.

We host our products and serve all of our customers from two third-party data center facilities located in Virginia and Illinois. While we operate our equipment inside these facilities, we do not control the operation of either of these facilities, and, depending on service level requirements, we may not continue to operate or maintain redundant data center facilities for all of our products or for all of our data, which could increase our vulnerability. These facilities are vulnerable to damage or interruption from earthquakes, hurricanes, floods, fires, power loss, telecommunications failures and similar events. They are also subject to break-ins, computer viruses, sabotage, intentional acts of vandalism and other misconduct. A natural disaster or an act of terrorism, a decision to close the facilities without adequate notice or other unanticipated problems could result in lengthy interruptions in availability of our products. We may also encounter capacity limitations at our third-party data centers. Additionally, our data center facility agreements are of limited durations, and our data center facilities have no obligation to renew their agreements with us on commercially reasonable terms, if at all. Our agreement for our data center facility located in Virginia expires on October 3, 2008, if not renewed, and our agreement for our data center facility located in Illinois expires on April 28, 2008, if not renewed. Although we are not substantially dependent on either data center facility because of planned redundancies, and although we currently are able to migrate to alternative data centers, such a migration may result in an interruption or delay in service. If we are unable to renew our agreements with the owners of the facilities on commercially reasonable terms, or if we migrate to a new data center, we may experience delays in delivering our products until an agreement with another data center facility can be arranged or the migration to a new facility is completed.

Further, we depend on access to the Internet through third-party bandwidth providers to operate our business. If we lose the services of one or more of our bandwidth providers for any reason, we could experience disruption in the delivery of our products or be required to retain the services of a replacement bandwidth provider. It may be difficult for us to replace any lost bandwidth on commercially reasonable terms, or at all, due to the large amount of bandwidth our operations require.

Our operations also rely heavily on the availability of electrical power and cooling capacity, which are also supplied by third-party providers. If we or the third-party data center operators that we use to deliver our products were to experience a major power outage or if the cost of electrical power increases significantly, our operations and profitability would be harmed. If we or the third-party data centers that we use were to experience a major power outage, we would have to rely on back-up generators, which may not function properly, and their supply may be inadequate. Such a power outage could result in the disruption of our business. Additionally, if our current facilities fail to have sufficient cooling capacity or availability of electrical power, we would need to find alternative facilities.

Any errors, defects, disruptions or other performance problems with our products caused by third parties could harm our reputation and may damage our business. Interruptions in the availability of our products may reduce our revenues due to increased turnaround time to complete projects, cause us to issue credits to customers, cause customers to terminate their subscription and project agreements or adversely affect our renewal rates. Our business would be harmed if our customers or potential customers believe our products are unreliable.

Because our long-term success depends, in part, on our ability to expand the sales of our products to customers located outside of the United States, our business will become increasingly susceptible to risks associated with international operations.

We have very limited experience operating in markets outside of the United States. Our inexperience in operating our business outside of the United States may increase the risk that the international expansion efforts we have begun to undertake will not be successful. In addition, conducting international operations subjects us to new risks that we have not generally faced in the United States. These risks include:

- recruitment and maintenance of a sufficiently large and representative panel both globally and in certain countries;

- different customer needs and buying behavior than we are accustomed to in the United States;

difficulties and expenses associated with tailoring our products to local markets, including their translation into foreign languages;

difficulties in staffing and managing international operations;

longer accounts receivable payment cycles and difficulties in collecting accounts receivable;

potentially adverse tax consequences, including the complexities of foreign value-added taxes and restrictions on the repatriation of earnings;

reduced or varied protection for intellectual property rights in some countries;

the burdens of complying with a wide variety of foreign laws and regulations;

fluctuations in currency exchange rates;

increased accounting and reporting burdens and complexities; and

political, social and economic instability abroad, terrorist attacks and security concerns.

Additionally, operating in international markets requires significant management attention and financial resources. We cannot be certain that the investments and additional resources required to establish and maintain operations in other countries will hold their value or produce desired levels of revenues or profitability. We cannot be certain that we will be able to maintain and increase the size of the Internet user panel that we currently have in various countries or that we will be able to recruit a representative sample for our audience measurement products. In addition, there can be no assurance that Internet usage and eCommerce will continue to grow in international markets. In addition, governmental authorities in various countries have different views regarding regulatory oversight of the Internet. For example, the Chinese government has recently taken steps to restrict the content available to Internet users in China.

The impact of any one or more of these risks could negatively affect or delay our plans to expand our international business and, consequently, our future operating results.

If we fail to respond to technological developments, our products may become obsolete or less competitive.

Our future success will depend in part on our ability to modify or enhance our products to meet customer needs, to add functionality and to address technological advancements. For example, online publishers and advertisers have recently started to use Asynchronous JavaScript and XML, or AJAX, a development technique that allows Web applications to quickly make incremental updates without having to refresh the entire Web page. AJAX may make page views a less useful metric for measuring the usage and effectiveness of online media. If our products are not effective at addressing evolving customer needs that result from increased AJAX usage, our business may be harmed. Similarly, technological advances in the handheld device industry may lead to changes in our customers requirements. For example, if certain handheld devices become the primary mode of receiving content and conducting transactions on the Internet, and we are unable to adapt our software to collect information from such devices, then we would not be able to report on online activity. To remain competitive, we will need to develop new products that address these evolving technologies and standards. However, we may be unsuccessful in identifying new product opportunities or in developing or marketing new products in a timely or cost-effective manner. In addition, our product innovations may not achieve the market penetration or price levels necessary for profitability. If we are unable to develop enhancements to, and new features for, our existing products or if we are unable to develop new products that keep pace with rapid technological developments or changing industry standards, our products may become obsolete, less marketable and less competitive, and our business will be harmed.

The success of our business depends in large part on our ability to protect and enforce our intellectual property rights.

We rely on a combination of patent, copyright, service mark, trademark and trade secret laws, as well as confidentiality procedures and contractual restrictions, to establish and protect our proprietary rights, all of which provide only limited protection. While we have filed a number of patent applications and own one issued patent, we cannot assure you that any additional patents will be issued with respect to any of our pending or future patent applications, nor can we assure you that any patent issued to us will provide adequate protection, or that any patents issued to us will not be challenged, invalidated, circumvented, or held to be unenforceable in actions against alleged infringers. Also, we cannot assure you that any future trademark or service mark registrations will be issued with respect to pending or future applications or that any of our

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registered trademarks and service marks will be enforceable or provide adequate protection of our proprietary rights. Furthermore, adequate (or any) patent, trademark, service mark, copyright and trade secret protection may not be available in every country in which our services are available.

We endeavor to enter into agreements with our employees and contractors and with parties with whom we do business in order to limit access to and disclosure of our proprietary information. We cannot be certain that the steps we have taken will prevent unauthorized use of our technology or the reverse engineering of our technology. Moreover, third parties might independently develop technologies that are competitive to ours or that infringe upon our intellectual property. In addition, the legal standards relating to the validity, enforceability and scope of protection of intellectual property rights in Internet-related industries are uncertain and still evolving, both in the United States and in other countries. The protection of our intellectual property rights may depend on our legal actions against any infringers being successful. We cannot be sure any such actions will be successful.

An assertion from a third party that we are infringing its intellectual property, whether such assertions are valid or not, could subject us to costly and time-consuming litigation or expensive licenses.

The Internet, software and technology industries are characterized by the existence of a large number of patents, copyrights, trademarks and trade secrets and by frequent litigation based on allegations of infringement or other violations of intellectual property rights, domestically or internationally. As we grow and face increasing competition, the probability that one or more third parties will make intellectual property rights claims against us increases. In such cases, our technologies may be found to infringe on the intellectual property rights of others. Additionally, many of our subscription agreements may require us to indemnify our customers for third-party intellectual property infringement claims, which would increase our costs if we have to defend such claims and may require that we pay damages and provide alternative services if there were an adverse ruling in any such claims. Intellectual property claims could harm our relationships with our customers, deter future customers from subscribing to our products or expose us to litigation. Even if we are not a party to any litigation between a customer and a third party, an adverse outcome in any such litigation could make it more difficult for us to defend against intellectual property claims by the third party in any subsequent litigation in which we are a named party. Any of these results could adversely affect our brand, business and results of operations.

One of our competitors has filed patent infringement lawsuits against others, demonstrating this party s propensity for patent litigation. It is possible that this third party, or some other third party, may bring an action against us, and thus cause us to incur the substantial costs and risks of litigation. Any intellectual property rights claim against us or our customers, with or without merit, could be time-consuming and expensive to litigate or settle and could divert management resources and attention. An adverse determination also could prevent us from offering our products to our customers and may require that we procure or develop substitute products that do not infringe on other parties rights.

With respect to any intellectual property rights claim against us or our customers, we may have to pay damages or stop using technology found to be in violation of a third party s rights. We may have to seek a license for the technology, which may not be available on reasonable terms or at all, may significantly increase our operating expenses or may significantly restrict our business activities in one or more respects. We may also be required to develop alternative non-infringing technology, which could require significant effort and expense. Any of these outcomes could adversely affect our business and results of operations.

Domestic or foreign laws, regulations or enforcement actions may limit our ability to collect and use information about Internet users or restrict or prohibit our product offerings, causing a decrease in the value of our products and an adverse impact on the sales of our products.

Our business could be adversely impacted by existing or future laws or regulations of, or actions by, domestic or foreign regulatory agencies. For example, privacy concerns could lead to legislative, judicial and regulatory limitations on our ability to collect, maintain and use information about Internet users in the United States and abroad. Various state legislatures, including those of Utah and California, have enacted legislation designed to protect Internet users privacy, for example by prohibiting spyware. In recent years, similar legislation has been proposed in other states and at the federal level and has been enacted in foreign countries, most notably by the European Union, which adopted a privacy directive regulating the collection of personally identifiable information online. These laws and regulations, if drafted or interpreted broadly, could be deemed to apply to the technology we use, and could restrict our information collection methods or decrease the amount and utility of the information that we would be permitted to collect. In addition, our ability to conduct business in certain foreign jurisdictions, including China, is restricted by the laws, regulations and agency actions of those jurisdictions. The costs of compliance with, and the other burdens imposed by, these and other laws or regulatory actions may prevent us from selling our products or increase the costs associated with selling our products, and may affect our ability to invest in or jointly develop products in the United States and in foreign jurisdictions.

In addition, failure to comply with these and other laws and regulations may result in, among other things, administrative enforcement actions and fines, class action lawsuits and civil and criminal liability. State attorneys general, governmental and non-governmental entities and private persons may bring legal actions asserting that our methods of collecting, using and distributing Web site visitor information are illegal or improper, which could require us to spend significant time and resources defending these claims. For example, some companies that collect, use and distribute Web site visitor information have been the subject of governmental investigations and class-action lawsuits. Any such regulatory or civil action that is brought against us, even if unsuccessful, may distract our management s attention, divert our resources, negatively affect our public image or reputation among our panelists and customers and harm our business.

The impact of any of these current or future laws or regulations could make it more difficult or expensive to attract or maintain panelists, particularly in affected jurisdictions, and could adversely affect our business and results of operations.

Laws related to the regulation of the Internet could adversely affect our business.

Laws and regulations that apply to communications and commerce over the Internet are becoming more prevalent. In particular, the growth and development of the market for eCommerce has prompted calls for more stringent tax, consumer protection and privacy laws in the United States and abroad that may impose additional burdens on companies conducting business online. The adoption, modification or interpretation of laws or regulations relating to the Internet or our customers digital operations could negatively affect the businesses of our customers and reduce their demand for our products.

If we fail to respond to evolving industry standards, our products may become obsolete or less competitive.

The market for our products is characterized by rapid technological advances, changes in customer requirements, changes in protocols and evolving industry standards. For example, industry associations such as the Advertising Research Foundation, the Council of American Survey Research Organizations, the Internet Advertising Bureau, or IAB, and the Media Ratings Council have independently initiated efforts to either review online market research methodologies or to develop minimum standards for online market research. On April 19, 2007, we received a letter from the IAB, citing discrepancies between our audience measurement data, those of our competitors and those provided by the server logs of IAB s member organizations. In its letter, the IAB asked us to submit to an independent audit and accreditation process of our audience measurement systems and processes. On May 16, 2007, we attended a meeting hosted by the IAB in which we indicated a commitment to finalizing a timeline for a full audit and accreditation by the Media Ratings Council within the 90 days of the meeting.

Any standards adopted by the IAB or similar organizations may lead to costly changes to our procedures and methodologies. As a result, the cost of developing our digital marketing intelligence products could increase. If we do not adhere to standards prescribed by the IAB or other industry associations, our customers could choose to purchase products from competing companies that meet such standards. Furthermore, industry associations based in countries outside of the United States often endorse certain vendors or methodologies. If our methodologies fail to receive an endorsement from an important industry association located in a foreign country, advertising agencies, media companies and advertisers in that country may not purchase our products. As a result, our efforts to further expand internationally could be adversely affected.

The success of our business depends on the continued growth of the Internet as a medium for commerce, content, advertising and communications.

Expansion in the sales of our products depends on the continued acceptance of the Internet as a platform for commerce, content, advertising and communications. The use of the Internet as a medium for commerce, content, advertising and communications could be adversely impacted by delays in the development or adoption of new standards and protocols to handle increased demands of Internet activity, security, reliability, cost, ease-of-use, accessibility and quality-of-service. The performance of the Internet and its acceptance as a medium for commerce, content commerce, content, advertising and communications has been harmed by viruses, worms, and similar malicious programs, and the Internet has experienced a variety of outages and other delays as a result of damage to portions of its infrastructure. If for any reason the Internet does not remain a medium for widespread commerce, content, advertising and communications, the demand for our products would be significantly reduced, which would harm our business.

We rely on our management team and need additional personnel to grow our business, and the loss of one or more key employees or the inability to attract and retain qualified personnel could harm our business.

Our success and future growth depends to a significant degree on the skills and continued services of our management team, including our founders, Magid M. Abraham, Ph.D. and Gian M. Fulgoni. Our future success also depends on our ability to retain, attract and motivate highly skilled technical, managerial, marketing and customer service personnel, including members of our management team. All of our employees work for us on an at-will basis. We plan to hire additional personnel in all areas of our business, particularly for our sales, marketing and technology development areas, both domestically and internationally, which will likely increase our recruiting and hiring costs. Competition for these types of personnel is intense, particularly in the Internet and software industries. As a result, we may be unable to successfully attract or retain qualified personnel. Our inability to retain and attract the necessary personnel could adversely affect our business.

We may expand through investments in, or acquisitions of, other companies, any of which may not be successful and may divert our management s attention.

Our business strategy may include acquiring complementary products, technologies or businesses. We also may enter into relationships with other businesses in order to expand our product offerings, which could involve preferred or exclusive licenses, discount pricing or investments in other companies.

Negotiating any such transactions could be time-consuming, difficult and expensive, and our ability to close these transactions may be subject to regulatory or other approvals and other conditions which are beyond our control. Consequently, we can make no assurances that any such transactions, if undertaken and announced, would be completed.

An acquisition, investment or business relationship may result in unforeseen operating difficulties and expenditures. In particular, we may encounter difficulties assimilating or integrating the businesses, technologies, products, personnel or operations of the acquired companies, particularly if the key personnel of the acquired company choose not to be employed by us, and we may have difficulty retaining the customers of any acquired business due to changes in management and ownership. Acquisitions may also disrupt our ongoing business, divert our resources and require significant management attention that would otherwise be available for ongoing development of our business. Moreover, we cannot assure you that the anticipated benefits of any acquisition, investment or business relationship would be realized or that we would not be exposed to unknown liabilities. In connection with any such transaction, we may:

encounter difficulties retaining key employees of the acquired company or integrating diverse business cultures;

issue additional equity securities that would dilute the common stock held by existing stockholders;

incur large charges or substantial liabilities;

become subject to adverse tax consequences, substantial depreciation or deferred compensation charges;

use cash that we may need in the future to operate our business; and

incur debt on terms unfavorable to us or that we are unable to repay.

The impact of any one or more of these factors could adversely affect our business or results of operations or cause the price of our common stock to decline substantially.

Changes in, or interpretations of, accounting rules and regulations, including recent rules and regulations regarding expensing of stock options, could result in unfavorable accounting charges or cause us to change our compensation policies.

Accounting methods and policies, including policies governing revenue recognition, expenses and accounting for stock options are continually subject to review, interpretation, and guidance from relevant accounting authorities, including the Financial Accounting Standards Board, or FASB, and the SEC. Changes to, or interpretations of, accounting methods or policies in the future may require us to reclassify, restate or otherwise change or revise our financial statements, including those contained in this prospectus.

On December 16, 2004, the FASB issued SFAS No. 123R (revised 2004), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123R). SFAS No. 123R supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123R is similar to the approach described in SFAS No. 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. We were required to adopt SFAS No. 123R on January 1, 2006, and have adopted it as of that date.

As permitted by SFAS No. 123, we accounted for share-based payments to employees through December 31, 2005 using APB Opinion No. 25 s intrinsic value method and, as such, generally recognized no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123R s fair value method has had a significant impact on the presentation of our results of operations, although it has not impacted our overall financial position. The long-term impact of adoption of SFAS No. 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future and the assumptions for the variables which impact the computation of the fair value of any such grants.

Historically, we have used stock options as part of our compensation programs to motivate and retain existing employees and to attract new employees. Because we are now required to expense stock options, we may choose to reduce our reliance on stock options as part of our compensation packages. If we reduce our use of stock options, it may be more difficult for us to retain and attract qualified employees. If we do not reduce our use of stock options, our expenses in future periods may increase. Beginning in 2007, we issued restricted stock awards and restricted stock units, and we expect to reduce our use of stock options as a form of stock-based compensation, but we cannot be certain whether or how our stock-based compensation policy will change in the future.

Investors could lose confidence in our financial reports, and our business and stock price may be adversely affected, if our internal control over financial reporting is found by management or by our independent registered public accounting firm to not be adequate or if we disclose significant existing or potential deficiencies or material weaknesses in those controls.

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to include a report on our internal control over financial reporting in our Annual Report on Form 10-K for each year beginning with the year ending December 31, 2008. That report must include management s assessment of the effectiveness of our internal control over financial reporting as of the end of that and each subsequent fiscal year. Additionally, our independent registered public accounting firm will be required to issue a report on management s assessment of our internal control over financial reporting and on their evaluation of the operating effectiveness of our internal control over financial reporting.

We continue to evaluate our existing internal controls against the standards adopted by the Public Company Accounting Oversight Board, or PCAOB. During the course of our ongoing evaluation of our internal controls, we have in the past identified, and may in the future identify, areas requiring improvement, and may have to design enhanced processes and controls to address issues identified through this review. Remedying any significant deficiencies or material weaknesses that we or our independent registered public accounting firm may identify could require us to incur significant costs and expend significant time and management resources. We cannot assure you that any of the measures we may implement to remedy any such deficiencies will effectively mitigate or remedy such deficiencies. In addition, we cannot assure you that we will be able to complete the work necessary for our management to issue its management report in a timely manner, or that we will be able to complete any work required for our management to be able to conclude that our internal control over financial reporting is operating effectively. If we are not able to complete the assessment under Section 404 in a timely manner or to remedy any identified material weaknesses, we and our independent registered public accounting firm would be unable to conclude that our internal control over financial reporting is effective as of December 31, 2008. If our internal control over financial reporting is found by management or by our independent registered public accountant to not be adequate or if we disclose significant existing or potential deficiencies or material weaknesses in those controls, investors could lose confidence in our financial reports, we could be subject to sanctions or investigations by The NASDAQ Global Market, the Securities and Exchange Commission or other regulatory authorities and our stock price could be adversely affected.

A determination that there is a significant deficiency or material weakness in the effectiveness of our internal control over financial reporting could also reduce our ability to obtain financing or could increase the cost of any financing we obtain and require additional expenditures to comply with applicable requirements.

Our net operating loss carryforwards may expire unutilized or underutilized, which could prevent us from offsetting future taxable income.

We have experienced changes in control that have triggered the limitations of Section 382 of the Internal Revenue Code on our net operating loss carryforwards. As a result, we may be limited in the portion of net operating loss carryforwards that we can use in the future to offset taxable income for U.S. Federal income tax purposes.

At December 31, 2006, we had both federal and state net operating loss carryforwards of approximately $81.2 million, which are available to offset future taxable income. The federal net operating loss carryforwards will begin to expire in 2020. The state net operating loss carryforwards begin to expire in 2010.

In addition, at December 31, 2005 and 2006, we had net operating loss carryforwards for tax purposes related to our foreign subsidiaries of $966,000 and $703,000, respectively, which begin to expire in 2010.

In 2006, deferred tax assets, before valuation allowance, decreased approximately $2.4 million due to our use of net operating loss carryforwards to offset taxable income.

We periodically assess the likelihood that we will be able to recover our deferred tax assets. We consider all available evidence, both positive and negative, including historical levels of income, expectations and risks associated with estimates of future taxable income and ongoing prudent and feasible profits. As a result of this analysis of all available evidence, both positive and negative, we concluded that a full valuation allowance against deferred tax assets should be applied as of December 31, 2006. To the extent we determine that all or a portion of our valuation allowance is no longer necessary, we will recognize an income tax benefit in the period such determination is made for the reversal of the valuation allowance. Once the valuation allowance is eliminated or reduced, its reversal will no longer be available to offset our current tax provision. These events could have a material impact on our reported results of operations.

We may require additional capital to support business growth, and this capital may not be available on acceptable terms or at all.

We intend to continue to make investments to support our business growth and may require additional funds to respond to business challenges, including the need to develop new products or enhance our existing products, enhance our operating infrastructure and acquire complementary businesses and technologies.

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Accordingly, we may need to engage in equity or debt financings to secure additional funds. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. Any debt financing secured by us in the future could include restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. In addition, we may not be able to obtain additional financing on terms favorable to us or at all. If we are unable to obtain adequate financing or financing on terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited. In addition, the terms of any additional equity or debt issuances may adversely affect the value and price of our common stock.

Risks Related to this Offering

We cannot assure you that a market will develop for our common stock or what the market price of our common stock will be.

Before this offering, there was no public trading market for our common stock, and we cannot assure you that one will develop or be sustained after this offering. If a market does not develop or is not sustained, it may be difficult for you to sell your shares of common stock at an attractive price or at all. We cannot predict the prices at which our common stock will trade.

The initial public offering price for our common stock will be determined through our negotiations with the underwriters, and may not bear any relationship to the market price at which our common stock will trade after this offering or to any other established criteria of the value of our business. The price of our common stock that will prevail in the market after this offering may be higher or lower than the price you pay, depending on many factors, some of which are beyond our control and may not be related to our operating performance. It is possible that, in future quarters, our operating results may be below the expectations of securities analysts or investors. As a result of these and other factors, the price of our common stock may decline, possibly materially. These fluctuations could cause you to lose all or part of your investment in our common stock. The public trading price for our common stock after this offering will be affected by a number of factors, including:

- price and volume fluctuations in the overall stock market from time to time;
- volatility in the market price and trading volume of technology companies and of companies in our industry;
- actual or anticipated changes or fluctuations in our operating results;
- actual or anticipated changes in expectations regarding our performance by investors or securities analysts;
- the failure of securities analysts to cover our common stock after this offering or changes in financial estimates by analysts;
- actual or anticipated developments in our competitors businesses or the competitive landscape;
- actual or perceived inaccuracies in information we provide to our customers or the media;
- litigation involving us, our industry or both;
- regulatory developments;

privacy and security concerns, including public perception of our practices as an invasion of privacy;

general economic conditions and trends;

major catastrophic events;

sales of large blocks of our stock;

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the timing and success of new product introductions or upgrades by us or our competitors;

changes in our pricing policies or payment terms or those of our competitors;

concerns relating to the security of our network and systems;

our ability to expand our operations, domestically and internationally, and the amount and timing of expenditures related to this expansion; or

departures of key personnel.

In addition, the stock prices of many technology companies have experienced wide fluctuations that have often been unrelated to the operating performance of those companies.

In the past, following periods of volatility in the market price of a company s securities, securities class action litigation has often been brought against that company. If our stock price is volatile, we may become the target of securities litigation, which could result in substantial costs and divert our management s attention and resources from our business.

Our stock price could decline due to the large number of outstanding shares of our common stock eligible for future sale.

Sales of substantial amounts of our common stock in the public market following this offering, or the perception that these sales could occur, could cause the market price of our common stock to decline. These sales could also make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate.

Upon completion of this offering, we will have outstanding shares of common stock, assuming no exercise of the underwriters over-allotment option and no exercise of outstanding options or warrants after , 2007. The shares sold pursuant to this offering will be immediately tradable without restriction. Of the remaining shares:

shares will be eligible for sale immediately upon completion of this offering, subject in some cases to volume and other restrictions of Rule 144 and Rule 701 under the Securities Act;

shares will be eligible for sale upon the expiration of lock-up agreements, subject in some cases to volume and other restrictions of Rule 144 and Rule 701 under the Securities Act; and

shares will be eligible for sale upon the exercise of vested options after the expiration of the lock-up agreements.

The lock-up agreements expire 180 days after the date of this prospectus, provided that the 180-day period may be extended in certain cases for up to 34 additional days under certain circumstances where we announce or pre-announce earnings or a material event within approximately 17 days prior to, or approximately 16 days after, the termination of the 180-day period. Credit Suisse Securities (USA) LLC may, in its sole discretion and at any time without notice, release all or any portion of the securities subject to lock-up agreement. After the closing of this offering, we intend to register approximately shares of common stock that have been reserved for future issuance under our stock incentive plans.

Insiders will continue to have substantial control over us after this offering, which could limit your ability to influence the outcome of key transactions, including a change of control.

Our directors, executive officers and each of our stockholders who own greater than 5% of our outstanding common stock and their affiliates, in the aggregate, will beneficially own approximately % of the outstanding shares of our common stock after this offering. As a result, these stockholders, if acting together, would be able to influence or control matters requiring approval by our stockholders, including the election of directors and the approval of mergers, acquisitions or other extraordinary transactions. They may have interests that differ from yours and may vote in a way with which you disagree and which may be adverse to your interests. This concentration of ownership may have the effect of delaying, preventing or deterring a change of control of our company, could

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deprive our stockholders of an opportunity to receive a premium for their common stock as part of a sale of our company and might affect the market price of our common stock.

Our management will have broad discretion over the use of the proceeds from this offering and may not apply the proceeds of this offering in ways that increase the value of your investment.

Our management will have broad discretion to use the net proceeds we receive from this offering, and you will be relying on its judgment regarding the application of these proceeds. We expect to use the net proceeds from this offering for general corporate purposes, which may include working capital, capital expenditures, other corporate expenses and potential acquisitions of complementary products, technologies or businesses. We have not allocated these net proceeds for any specific purposes. However, management may not apply the net proceeds of this offering in ways that increase the value of your investment.

If you purchase shares of our common stock in this offering, you will experience substantial and immediate dilution.

If you purchase shares of our common stock in this offering, you will experience substantial and immediate dilution of $ per share based on an assumed initial public offering price of $ per share, the mid-point of the range shown on the cover of this prospectus, because the price that you pay will be substantially greater than the net tangible book value per share of the common stock that you acquire. This dilution is due in large part to the fact that our earlier investors paid substantially less than the initial public offering price when they purchased their shares of our capital stock. You will experience additional dilution upon the exercise of options to purchase common stock under our equity incentive plans, if we issue restricted stock to our employees under these plans or if we otherwise issue additional shares of our common stock. See Dilution.

We will incur increased costs and demands upon management as a result of complying with the laws and regulations affecting a public company, which could adversely affect our operating results.

As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act of 2002, as well as rules implemented by the Securities and Exchange Commission and The NASDAQ Stock Market, requires certain corporate governance practices for public companies. Our management and other personnel will need to devote a substantial amount of time to public reporting requirements and corporate governance. We expect these rules and regulations to significantly increase our legal and financial compliance costs and to make some activities more time-consuming and costly. We will also incur additional costs associated with our public company reporting requirements. We are unable to currently estimate these costs with any degree of certainty. If these costs are not offset by increased revenues and improved financial performance, our operating results would be adversely affected. We also expect these rules and regulations to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified people to serve on our board of directors or as executive officers.

Provisions in our certificate of incorporation and bylaws and under Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.

Our certificate of incorporation and bylaws contain provisions that could depress the trading price of our common stock by acting to discourage, delay or prevent a change of control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions:

establish a classified board of directors so that not all members of our board of directors are elected at one time;

authorize blank check preferred stock that our board of directors could issue to increase the number of outstanding shares to discourage a takeover attempt;

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prohibit stockholder action by written consent, which means that all stockholder actions must be taken at a meeting of our stockholders;

prohibit stockholders from calling a special meeting of our stockholders;

provide that the board of directors is expressly authorized to make, alter or repeal our bylaws; and

establish advance notice requirements for nominations for elections to our board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings.

Additionally, we are subject to Section 203 of the Delaware General Corporation Law, which prohibits a Delaware corporation from engaging in any of a broad range of business combinations with any interested stockholder for a period of three years following the date on which the stockholder became an interested stockholder and which may discourage, delay or prevent a change of control of our company.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS AND INDUSTRY DATA

This prospectus, including the sections entitled Summary, Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and Business, contains forward-looking statements. These statements may relate to, but are not limited to, expectations of future operating results or financial performance, capital expenditures, introduction of new products, regulatory compliance, plans for growth and future operations, as well as assumptions relating to the foregoing. Forward-looking statements are inherently subject to risks and uncertainties, some of which cannot be predicted or quantified. These risks and other factors include, but are not limited to, those listed under Risk Factors. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expect, plan, anticipate, believe, estimate, predict, intend, potential, migh negative of these terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

We believe that it is important to communicate our future expectations to our investors. However, there may be events in the future that we are not able to accurately predict or control and that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. Except as required by applicable law, including the securities laws of the United States and the rules and regulations of the SEC, we do not plan to publicly update or revise any forward-looking statements after we distribute this prospectus, whether as a result of any new information, future events or otherwise. Potential investors should not place undue reliance on our forward-looking statements. Before you invest in our common stock, you should be aware that the occurrence of any of the events described in the Risk Factors section and elsewhere in this prospectus could harm our business, prospects, operating results and financial condition. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements.

This prospectus also contains estimates and other information concerning our industry, including market size and growth rates of the markets in which we participate, that are based on industry publications, surveys and forecasts, including those generated by Forrester Research, IDC, JupiterResearch, Infonetics, the Internet Advertising Bureau and PricewaterhouseCoopers. This information involves a number of assumptions and limitations, and you are cautioned not to give undue weight to these estimates. These industry publications, surveys and forecasts generally indicate that their information has been obtained from sources believed to be reliable. The industry in which we operate is subject to a high degree of uncertainty and risk due to a variety of factors, including those described in Risk Factors. These and other factors could cause actual results to differ materially from those expressed in these publications, surveys and forecasts.

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USE OF PROCEEDS

We estimate that the net proceeds from the sale of the shares of our common stock that we are selling in this offering will be approximately $ million, based on an assumed initial public offering price of $ per share, the mid-point of the range on the front cover of this prospectus, after deducting underwriting discounts and commissions and estimated offering expenses. If the underwriters over-allotment option is exercised in full, we estimate that we will receive additional net proceeds of approximately $ million. We will not receive any proceeds from the sale of shares of our common stock by the selling stockholders.

The principal purposes of this offering are to create a public market for our common stock and to facilitate our future access to the public equity markets, as well as to obtain additional capital.

Except as discussed below, we currently have no specific plans for the use of a significant portion of the net proceeds of this offering. However, we anticipate that we will use the net proceeds from this offering for general corporate purposes, which may include working capital, capital expenditures, other corporate expenses and acquisitions of complementary products, technologies or businesses. We expect to use approximately $4 million of the net proceeds for capital expenditures related to computer hardware and equipment as well as office improvements. We currently have no agreements or commitments with respect to acquisitions of complementary products, technologies or businesses. The timing and amount of our actual expenditures will be based on many factors, including cash flows from operations and the anticipated growth of our business. Pending these uses, we intend to invest the net proceeds of this offering primarily in short-term, investment-grade, interest-bearing instruments.

If we were to price the offering at $ per share, the low end of the range on the cover of this prospectus, we estimate that we would receive net proceeds of $ million, assuming the total number of shares offered by us remains the same and after deducting underwriting discounts and commissions and estimated offering expenses payable by us. If we were to price the offering at $ per share, the high end of the range on the cover of this prospectus, then we estimate that we would receive net proceeds of $ million, assuming the total number of shares offered by us remains the same and after deducting underwriting discounts and commissions and estimated offering expenses payable by us.

DIVIDEND POLICY

We have never declared or paid any dividends on our capital stock. We anticipate that we will retain any earnings to support operations and to finance the growth and development of our business. Accordingly, we do not expect to pay cash dividends on our common stock in the foreseeable future.

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CAPITALIZATION

The following table sets forth our capitalization as of March 31, 2007:

on an actual basis without any adjustments to reflect subsequent or anticipated events;

on a pro forma basis reflecting (i) the conversion of all outstanding shares of our Series A, Series B, Series C, Series C-1, Series D and Series E preferred stock into an aggregate of 86,286,697 shares of our common stock effective immediately prior to the completion of this offering, for a total of 111,915,643 shares of common stock, which amount includes 1,738,172 shares subject to put and (ii) the reclassification of our preferred stock warrant liabilities from current liabilities to additional paid in capital effective upon the completion of this offering; and

on a pro forma as adjusted basis reflecting the conversion and reclassification described above and the receipt by us of the net proceeds from the sale of shares of common stock in this offering at an assumed initial public offering price of $ per share, after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

You should read this table in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this prospectus.

	As of March 31, 2007		
	Actual	Pro Forma	Pro Forma as Adjusted
	(In thousands, except share data)		
Preferred stock warrant liabilities	995		
Redeemable preferred stock, $0.001 par value, 73,673,224 shares authorized; 71,829,471 shares issued and outstanding actual; no shares issued or outstanding pro forma and pro forma as adjusted	102,580		
Common stock subject to put right, 1,738,172 shares outstanding	4,392	4,392	
Stockholders equity (deficit):			
Common stock, $0.001 par value; 130,000,000 shares authorized, 23,890,774 shares issued and outstanding actual; 150,000,000 shares authorized, 110,177,471 shares issued and outstanding pro forma and shares issued and outstanding pro forma as adjusted	24	110	
Additional paid-in capital		103,489	
Accumulated other comprehensive loss	(70)	(70)	
Accumulated deficit	(98,637)	(98,637)	
Total stockholders equity (deficit)	(98,683)	4,892	
Total capitalization	$ 9,284	$ 9,284	

The table above excludes, as of March 31, 2007:

- 12,486,511 shares of common stock issuable upon exercise of options outstanding at a weighted-average exercise price of $0.41 per share;

- 264,250 shares of our common stock issuable upon the settlement of outstanding restricted stock unit awards;

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2,295,125 shares of common stock reserved for future issuance under our 1999 Stock Plan;

7,000,000 shares of common stock reserved for future issuance under our 2007 Equity Incentive Plan, which will be effective upon completion of this offering; and

875,923 shares of common stock issuable upon the exercise of warrants, which total includes warrants for our preferred stock that will become exercisable for common stock after this offering, at a weighted-average exercise price of $0.97 per share.

A $1.00 decrease or increase in the offering price would result in an approximately $ million increase or decrease in each of as adjusted cash and cash equivalents, as adjusted additional paid-in capital, as adjusted total stockholders equity and as adjusted total capitalization, assuming the total number of shares offered by us remains the same and after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us.

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DILUTION

If you invest in our common stock, your interest will be diluted to the extent of the difference between the public offering price per share of our common stock and the pro forma as adjusted net tangible book value per share of our common stock after this offering. Our pro forma net tangible book value as of March 31, 2007 was $6.2 million, or $0.06 per share of common stock. Pro forma net tangible book value per share represents total tangible assets less total liabilities, divided by the number of shares of common stock outstanding after giving effect to the conversion of all outstanding shares of our Series A, Series B, Series C, Series C-1, Series D and Series E preferred stock into an aggregate of 86,286,697 shares of our common stock effective immediately prior to the completion of this offering, for a total of 111,915,643 shares of common stock outstanding on March 31, 2007, which amount includes 1,738,172 shares subject to put. After giving effect to the sale by us of shares of our common stock in this offering at the assumed initial public offering price of $ per share, the mid-point of the range on the front cover of this prospectus, and after deducting the underwriting discounts and commissions and our estimated offering expenses, our pro forma as adjusted net tangible book value as of March 31, 2007 would have been $ million, or $ per share. This represents an immediate increase in net tangible book value of $ per share to our existing stockholders and an immediate dilution of $ per share to our new investors purchasing shares of common stock in this offering. The following table illustrates this dilution on a per share basis:

Assumed initial public offering price per share		$
Pro forma net tangible book value per share as of March 31, 2007	$ 0.06	
Increase in pro forma net tangible book value per share attributable to this offering per share to existing investors		
Pro forma as adjusted net tangible book value per share after this offering		
Dilution per share to new investors		$

The following table sets forth as of March 31, 2007, on a pro forma as adjusted basis, the differences between the number of shares of common stock purchased from us, the total consideration paid, and the average price per share paid by existing stockholders and new investors purchasing shares of our common stock in this offering based on an assumed initial public offering price of $ per share, the mid-point of the range on the front cover of this prospectus, and before deducting underwriting discounts and commissions and estimated offering expenses.

	Shares Purchased		Total Consideration		Average Price
	Number	Percent	Amount	Percent	per Share
Existing stockholders	111,915,643	%	$ 88,892,972	%	$ 0.79
New investors					
Total		100.0%	$	100.0%	$

If the underwriters exercise their over-allotment option in full, the percentage of shares of common stock held by existing stockholders will decrease to approximately % of the total number of shares of our common stock outstanding after this offering, and the number of shares held by new investors will be increased to , or approximately % of the total number of shares of our common stock outstanding after this offering.

A $1.00 decrease in the assumed offering price would decrease our net tangible book value after this offering by $ million and dilution in net tangible book value per share to new investors by $, assuming the total number of shares offered by us remains the same and after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us. A $1.00 decrease in the assumed offering price would decrease each of total consideration paid by new investors in the offering and total consideration paid by all stockholders by $ million, assuming the total number of shares offered by us remains the same and before deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us.

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A $1.00 increase in the assumed offering price would increase our net tangible book value after this offering by $ million and dilution in net tangible book value per share to new investors by $, assuming the total number of shares offered by us remains the same and after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us. A $1.00 increase in the assumed offering price would increase each of total consideration paid by new investors in the offering and total consideration paid by all stockholders by $ million, assuming the total number of shares offered by us remains the same and before deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us.

The table above excludes, as of March 31, 2007:

- 12,486,511 shares of common stock issuable upon exercise of options outstanding at a weighted-average exercise price of $0.41 per share;

- 264,250 shares of our common stock issuable upon the settlement of outstanding restricted stock unit awards;

- 2,295,125 shares of common stock reserved for future issuance under our 1999 Stock Plan;

- 7,000,000 shares of common stock reserved for future issuance under our 2007 Equity Incentive Plan, which will be effective upon completion of this offering; and

- 875,923 shares of common stock issuable upon the exercise of warrants, which total includes warrants for our preferred stock that will become exercisable for common stock after this offering, at a weighted-average exercise price of $0.97 per share.

Assuming the exercise of all options and warrants outstanding as of March 31, 2007, the effects would be as follows:

- pro forma as adjusted net tangible book value per share after this offering would decrease from $ to $, resulting in additional dilution to new investors of $ per share;

- our existing stockholders, including the holders of these options and warrants, would own %, and our new investors would own % of the total number of shares of our common stock outstanding upon the completion of this offering; and

- our existing stockholders, including the holders of these options and warrants, would have paid % of the total consideration, at an average price per share of $, and our new investors would have paid % of the total consideration.

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SELECTED CONSOLIDATED FINANCIAL DATA

You should read the selected consolidated financial data set forth below in conjunction with our consolidated financial statements, the notes to our consolidated financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations contained elsewhere in this prospectus.

The consolidated statements of operations data and the consolidated statements of cash flows data for the years ended January 31, 2003 and December 31, 2003 as well as the consolidated balance sheet data as of January 31, 2003 and December 31, 2003 and 2004 are derived from our audited consolidated financial statements not included in this prospectus. The consolidated statements of operations data and the consolidated statements of cash flows data for each of the three years ended December 31, 2004, 2005 and 2006 as well as the consolidated balance sheet data as of December 31, 2005 and 2006 are derived from our audited consolidated financial statements that are included elsewhere in this prospectus. In 2003, we changed our fiscal year to the twelve months ended December 31. The year ended January 31, 2003 and the year ended December 31, 2003 in the table below both include the results of operations for the month ended January 31, 2003. The consolidated statements of operations data for the three months ended March 31, 2006 and 2007 and the consolidated balance sheet data as of March 31, 2007 have been derived from our unaudited consolidated financial statements that are included elsewhere in this prospectus. We have prepared this unaudited financial information on the same basis as the audited consolidated financial statements and have included all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of our financial position and operating results for such period. The pro forma basic net income per share data are unaudited and give effect to the conversion into common stock of all outstanding shares of our Series A, Series B, Series C, Series C-1, Series D and Series E preferred stock from their dates of original issuance. Our historical results are not necessarily indicative of results to be expected for future periods. Results for the three months ended March 31, 2007 are not necessarily indicative of results expected for the full year.

	Year Ended January 31, 2003	Year Ended December 31, 2003	2004	2005	2006	Three Months Ended March 31, 2006	2007
						(Unaudited)	
	(In thousands, except share and per share data)						
onsolidated atement of perations Data:							
evenues	$ 15,400	$ 23,355	$ 34,894	$ 50,267	$ 66,293	$ 14,985	$ 18,68
ost of venues(1)	14,925	15,671	13,153	18,218	20,560	5,148	5,38
lling and arketing(1)	9,134	11,677	13,890	18,953	21,473	5,345	6,45
esearch and velopment(1)	6,172	5,444	5,493	7,416	9,009	2,137	2,55
eneral and ministrative(1)	4,431	4,124	4,982	7,089	8,293	1,918	2,50
mortization	562	772	356	2,437	1,371	371	29
otal expenses om operations	35,224	37,688	37,874	54,113	60,706	14,919	17,19
oss) income om operations	(19,824)	(14,333)	(2,980)	(3,846)	5,587	66	1,48
terest (expense) come, net	(885)	(595)	(246)	(208)	231	11	9
oss) gain from reign currency				(96)	125	6	(
evaluation of eferred stock arrant liabilities				(14)	(224)	2	1
oss) income fore income xes and mulative effect change in counting inciple	(20,709)	(14,928)	(3,226)	(4,164)	5,719	85	1,58
enefit) ovision for come taxes				(182)	50		4
et (loss) income fore cumulative fect of change	(20,709)	(14,928)	(3,226)	(3,982)	5,669	85	1,54

accounting inciple							
umulative effect change in counting inciple				(440)			
et (loss) income	(20,709)	(14,928)	(3,226)	(4,422)	5,669	85	1,540
ccretion of deemable eferred stock	(2,742)	(3,795)	(2,141)	(2,638)	(3,179)	(742)	(885
et (loss) income ributable to mmon ockholders	$ (23,451)	$ (18,723)	$ (5,367)	$ (7,060)	$ 2,490	$ (657)	$ 655
et (loss) income ributable to mmon ockholders per mmon share:							
asic and diluted	$ (1.82)	$ (1.39)	$ (0.38)	$ (0.46)	$ 0.00	$ (0.04)	$ 0.00
eighted-average mber of shares ed in per share lculations:							
asic and diluted	12,918,989	13,451,440	14,358,561	15,650,969	19,236,064	18,049,639	20,754,230
o forma net oss) income ributable to mmon ockholders per mmon share:							
asic							
luted							
o forma eighted-average mber of shares ed in per share lculations:							
asic							
luted							

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(1) Amortization of stock-based compensation is included in the line items above as follows:

	Year Ended January 31, 2003	Year Ended December 31, 2003	2004	2005	2006	Three Months Ended March 31, 2006 (Unaudited)	2007
	(In thousands)						
Cost of revenues	$	$	$	$	$ 12	$	$ 9
Selling and marketing					82	6	39
Research and development					13		8
General and administrative	128	171	14	3	91	1	51

	As of January 31, 2003	As of December 31, 2003	2004	2005	2006	As of March 31, 2007 (Unaudited)
	(In thousands)					
Consolidated Balance Sheet Data:						
Cash, cash equivalents and short-term investments	$ 6,973	$ 9,557	$ 8,404	$ 9,174	$ 16,032	$ 18,181
Total current assets	11,778	15,482	15,678	20,792	31,493	34,520
Total assets	23,603	22,154	23,618	29,477	42,087	45,479
Total current liabilities	13,645	15,515	18,591	27,220	32,880	34,897
Equipment loan and capital lease obligations, long-term	4,072	2,421	1,438	1,283	2,261	1,896
Preferred stock warrant liabilities and common stock subject to put	404	349	(2,141)	4,997	5,362	5,387
Redeemable preferred stock	78,586	93,737	95,878	98,516	101,695	102,580
Stockholders deficit	(73,735)	(89,919)	(95,230)	(102,294)	(99,557)	(98,683)

	Year Ended January 31,	Year Ended December 31,	Three Months Ended March 31,

	2003	2003	2004	2005	2006	2006	2007
						(Unaudited)	
			(In thousands)				
Consolidated Statement of Cash Flows Data:							
Net cash provided by (used in) operating activities	$ (12,653)	$ (3,912)	$ 1,907	$ 4,253	$ 10,905	$ 2,824	$ 3,156
Depreciation and amortization	5,865	6,604	2,745	5,123	4,259	1,059	1,154
Capital expenditures	1,962	726	1,208	1,071	2,314	292	494
Other Financial and Operating Data (unaudited):							
Adjusted EBITDA(2)	$ (13,930)	$ (7,558)	$ (221)	$ 730	$ 9,945	$ 1,140	$ 2,750

(2) We define Adjusted EBITDA as net income plus the (benefit) provision for income taxes, depreciation, amortization of purchased intangible assets and stock-based compensation; plus interest expense (income) and other income. Adjusted EBITDA is not a measure of liquidity calculated in accordance with GAAP, and should be viewed as a supplement to not a substitute for our results of operations presented on the basis of GAAP. Adjusted EBITDA does not purport to represent cash flow provided by, or used in, operating activities as defined by GAAP. Our statement of cash flows presents our cash flow activity in

accordance with GAAP. Furthermore, Adjusted EBITDA is not necessarily comparable to similarly-titled measures reported by other companies.

We prepare Adjusted EBITDA to eliminate the impact of items that we do not consider indicative of our core operating performance. You are encouraged to evaluate these adjustments and the reasons we consider them appropriate for supplemental analysis. Our presentation of Adjusted EBITDA should not be construed as an implication that our future results will be unaffected by unusual or non-recurring items.

We believe Adjusted EBITDA is useful to an investor in evaluating our operating performance for the following reasons:

Adjusted EBITDA is widely used by investors to measure a company s operating performance without regard to items such as interest expense, taxes, depreciation and amortization, and stock-based compensation, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which assets were acquired;

analysts and investors use Adjusted EBITDA as a supplemental measure to evaluate the overall operating performance of companies in our industry;

we believe Adjusted EBITDA is an important indicator of our operating performance because it provides a link between profitability and operating cash flow. Although our cash flow from operations presented is a similar measure, Adjusted EBITDA is a better measure of our true operating results because it adjusts for the effects of collections of receivables, disbursements of payables, and other factors that are influenced by seasonal conditions; and

prior to January 1, 2006, we accounted for stock-based compensation plans under the recognition and measurement provision s of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation.* In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which is a revision of SFAS No. 123. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated fair values. Pro forma disclosure is no longer an alternative permitted under SFAS 123R. We adopted the provisions of SFAS 123R on January 1, 2006, using the prospective method. Unvested stock-based awards issued prior to January 1, 2006, the date that we adopted the provisions of SFAS 123R, were accounted for at the date of adoption using the intrinsic value method originally applied to those awards. We recorded approximately $198,000 in stock-based compensation expense subsequent to the adoption of SFAS 123R for the fiscal year ended December 31, 2006 as compared with approximately $14,000 and $3,000 for the years ended December 31, 2004 and 2005, respectively, prior to the adoption of SFAS 123R. By comparing our Adjusted EBITDA our investors can evaluate our operating results without the additional variations of stock compensation expense, which is not necessarily comparable from year to year due to the change in accounting treatment and is a non-cash expense that is not a primary measure of our operations.

Our management uses Adjusted EBITDA:

as a measure of operating performance, because it removes the impact of items not directly resulting from our core operations;

for planning purposes, including the preparation of our internal annual operating budget;

to allocate resources to enhance the financial performance of our business;

as a metric for evaluating the performance of Dr. Magid M. Abraham, our Chief Executive Officer, and Mr. Gian M. Fulgoni, our Executive Chairman of the Board of Directors. The Company uses Adjusted EBITDA as a quantitative metric for setting both Dr. Abraham and Mr. Fulgoni s respective salaries

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and bonuses. In addition, option grants held by both Dr. Abraham and Mr. Fulgoni include vesting which can be accelerated upon achieving certain targets tied to EBITDA;

to evaluate the effectiveness of our operational strategies; and

in communications with the board of directors, stockholders, analysts and investors concerning our financial performance.

We understand that although Adjusted EBITDA is frequently used by securities analysts, lenders, investors and others in their evaluation of companies, Adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis, of our results of operations as reported under GAAP. Some of these limitations are:

Adjusted EBITDA does not reflect our cash expenditures or future requirements for capital expenditures or other contractual commitments;

Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

Adjusted EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, related to our debts;

Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements; and

Other companies in our industry may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

A reconciliation of Adjusted EBITDA to net income, the most directly comparable GAAP measure, for each of the fiscal periods indicated is as follows:

	Year Ended January 31, 2003	Year Ended December 31, 2003	2004	2005	2006	Three Months Ended March 31, 2006 (Unaudited)	2007
	(In thousands)						
Net (loss) income	$ (20,708)	$ (14,928)	$ (3,226)	$ (4,422)	$ 5,669	$ 85	$ 1,540
(Benefit) provision for income taxes				(182)	50		46
Amortization	562	772	356	2,437	1,371	371	293
Depreciation	5,303	5,832	2,389	2,686	2,888	688	861
Stock-based compensation	28	171	14	3	198	7	107
Interest expense (income), net	885	595	246	208	(231)	(11)	(97)
Adjusted EBITDA	$ (13,930)	$ (7,558)	$ (221)	$ 730	$ 9,945	$ 1,140	$ 2,750

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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 in conjunction with our consolidated financial statements and the related notes to those statements included elsewhere in this prospectus. In addition to historical financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results and timing of selected events may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those discussed under Risk Factors and elsewhere in this prospectus. See Cautionary Note Regarding Forward-Looking Statements.

Overview

We provide a leading digital marketing intelligence platform that helps our customers make better-informed business decisions and implement more effective digital business strategies. Our products and solutions offer our customers deep insights into consumer behavior, including objective, detailed information regarding usage of their online properties and those of their competitors, coupled with information on consumer demographic characteristics, attitudes, lifestyles and offline behavior.

Our digital marketing intelligence platform is comprised of proprietary databases and a computational infrastructure that measures, analyzes and reports on digital activity. The foundation of our platform is data collected from our comScore panel of more than two million Internet users worldwide who have granted us explicit permission to confidentially measure their Internet usage patterns, online and certain offline buying behavior and other activities. By applying advanced statistical methodologies to our panel data, we project consumers online behavior for the total online population and a wide variety of user categories.

We deliver our digital marketing intelligence through our comScore Media Metrix product family and through comScore Marketing Solutions. Media Metrix delivers digital media intelligence by providing an independent, third-party measurement of the size, behavior and characteristics of Web site and online advertising network audiences among home, work and university Internet users as well as insight into the effectiveness of online advertising. Our Marketing Solutions products combine the proprietary information gathered from the comScore panel with the vertical industry expertise of comScore analysts to deliver digital marketing intelligence, including the measurement of online advertising effectiveness, customized for specific industries. We typically deliver our Media Metrix products electronically in the form of weekly, monthly or quarterly reports. Customers can access current and historical Media Metrix data and analyze these data anytime online. Our Marketing Solutions products are typically delivered on a monthly, quarterly or ad hoc basis through electronic reports and analyses.

Our company was founded in August 1999. By 2000, we had established a panel of Internet users and began delivering digital marketing intelligence products that measured online browsing and buying behavior to our first customers. We also introduced netScore, our initial syndicated Internet audience measurement product. We accelerated our introduction of new products in 2003 with the launch of Plan Metrix (formerly AiM 2.0), qSearch, the Campaign R/F (Reach and Frequency) analysis system and product offerings that measure online activity at the local market level. By 2004, we had built a global panel of over two million Internet users. In that year, in cooperation with Arbitron, we launched a service that provides ratings of online radio audiences. In 2005, we expanded our presence in Europe by opening an office in London. In 2006, we continued to expand our measurement capabilities with the launch of World Metrix, a product that provides worldwide data on digital media usage, and Video Metrix, our product that measures the audience for streaming online video.

We have complemented our internal development initiatives with select acquisitions. On June 6, 2002, we acquired certain Media Metrix assets from Jupiter Media Metrix, Inc. Through this acquisition, we acquired certain Internet audience measurement services that report details of Web site usage and visitor demographics. On July 28, 2004, we acquired the outstanding stock of Denaro and Associates, Inc, otherwise known as Q2 Brand Intelligence, Inc. or Q2, to improve our ability to provide our customers more robust survey research integrated with our underlying digital marketing intelligence platform. The total cost of the acquisition was approximately $3.3 million, consisting of cash and shares of our common stock. For the ninety-day period beginning July 28, 2007, the former shareholder of Q2 (or its transferees) has the right to sell 1,060,000 shares of our common stock back to us for an aggregate price of $2.65 million, or $2.50 per share. On January 4, 2005, we acquired the assets and assumed certain liabilities of SurveySite Inc., or SurveySite. Through this acquisition, we acquired proprietary Internet-based data-collection technologies and increased our customer penetration and revenues in the survey business. The total cost of the acquisition was approximately $3.6 million, consisting of cash and shares of our common stock. For the ninety-day period beginning January 1, 2008, the former shareholders of SurveySite (or their transferees) have the right to sell 678,172 shares of our common stock back to us for an aggregate price of approximately $1.8 million, or $2.67 per share.

Our total revenues have grown from $15.4 million during the fiscal year ending January 31, 2003 to $66.3 million during the fiscal year ended December 31, 2006, a compounded annual growth rate of approximately 63%. By comparison, our total expenses from operations have grown from $35.2 million to $60.7 million over the same period, a compounded annual growth rate of approximately 20%. The growth in our revenues was primarily the result of:

- increased sales to existing customers, as a result of our efforts to deepen our relationships with these clients by increasing their awareness of, and confidence in, the value of our digital marketing intelligence platform;
- growth in our customer base through the addition of new customers;
- increases in the prices of our products and services;
- the sales of new products to existing and new customers; and
- growth in sales outside of the U.S. as a result of entering into new international markets.

As of March 31, 2007, we had 743 customers, compared to 334 as of January 31, 2003. We sell most of our products through our direct sales force.

Our Revenues

We derive our revenues primarily from the fees that we charge for subscription-based products and customized projects. We define subscription-based revenues as revenues that we generate from products that we deliver to a customer on a recurring basis. We define project revenues as revenues that we generate from customized projects that are performed for a specific customer on a non-recurring basis. We market our subscription-based products, customized projects and survey services within the comScore Media Metrix product family and through comScore Marketing Solutions.

A significant characteristic of our business model is our large percentage of subscription-based contracts. Subscription-based revenues accounted for 78% of our total revenues in 2004 and decreased to 70% of total revenues in 2005 primarily due to the acquisition of SurveySite. Subscription-based revenues increased to 75% of total revenues in 2006 and to 77% of total revenues during the first quarter of 2007.

Many of our customers who initially purchased a customized project have subsequently purchased one of our subscription-based products. Similarly, many of our subscription-based customers have subsequently purchased additional customized projects.

Historically, we have generated most of our revenues from the sale and delivery of our products to companies and organizations located within the United States. We intend to expand our international revenues by selling our products and deploying our direct sales force model in additional international markets in the future. For the fiscal year ended December 31, 2006, our international revenues were $5.7 million, an increase of $2.4 million over international revenues of $3.4 million for the fiscal year ended December 31, 2005. For the three months ended March 31, 2007, our international revenues were $1.8 million, an increase of $670,000 over international revenues of $1.1 million for the three months ended March 31, 2006. International revenues comprised approximately 7%, 9% and 10% of our total revenues for the fiscal years ended December 31, 2005 and 2006 and the three months ended March 31, 2007, respectively.

We anticipate that revenues from our U.S. customers will continue to constitute the substantial majority of our revenues, but we expect that revenues from customers outside of the U.S. will increase as a percentage of total revenues as we build greater international recognition of our brand and expand our sales operations globally.

Subscription Revenues

We generate a significant proportion of our subscription-based revenues from our Media Metrix product family. Products within the Media Metrix family include Media Metrix 2.0, Plan Metrix, World Metrix and Video Metrix. We intend to commercially launch Ad Metrix in the second quarter of 2007. These product offerings provide subscribers with intelligence on digital media usage, audience characteristics, audience demographics and online and offline purchasing behavior. Customers who subscribe to our Media Metrix products are provided with login IDs to our Web site, have access to our database and can generate reports at anytime.

We also generate subscription-based revenues from certain reports and analyses provided through comScore Marketing Solutions, if that work is procured by customers for at least a nine month period and the customer enters into an agreement to continue or extend the work. Through our Marketing Solutions products, we deliver digital marketing intelligence relating to specific industries, such as automotive, consumer packaged goods, entertainment, financial services, media, pharmaceutical, retail, technology, telecommunications and travel. This marketing intelligence leverages our global consumer panel and extensive database to deliver information unique to a particular customer s needs on a recurring schedule, as well as on a continual-access basis. Our Marketing Solutions customer agreements typically include a fixed fee with an initial term of at least one year. We also provide these products on a non-subscription basis as described under Project Revenues below.

In addition, we generate subscription-based revenues from survey products that we sell to our customers. In conducting our surveys, we generally use our global Internet user panel. After questionnaires are distributed to the panel members and completed, we compile their responses and then deliver our findings to the customer, who also has ongoing access to the survey response data as they are compiled and updated over time. These data include responses and information collected from the actual survey questionnaire and can also include behavioral information that we passively collect from our panelists. If a customer contractually commits to having a survey conducted on a recurring basis, we classify the revenues generated from such survey products as subscription-based revenues. Approximately half of the revenues derived from survey products are generated on a subscription basis. Our contracts for survey services typically include fixed fee agreements that range from two months to one year.

Project Revenues

We generate project revenues by providing customized information reports to our customers on a non-recurring basis as part of our comScore Marketing Solutions. For example, a customer in the media industry might request a custom report that profiles the behavior of the customer s active online users and contrasts their market share and loyalty with similar metrics for a competitor s online user base. If this customer continues to request the report beyond an initial project term of at least nine months and enters into an agreement to purchase the report on a recurring basis, we begin to classify these future revenues as subscription-based.

In the second quarter of 2007, we intend to commercially launch Campaign Metrix, a product that will provide detailed information about online advertising campaigns. Project revenues from Campaign Metrix will be generated when a customer accesses or downloads a report through our Web site. Pricing for our Campaign Metrix product will initially be based on the scope of the information provided in the report generated by the customer.

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Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the amounts reported in our financial statements and the accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. While our significant accounting policies are described in more detail in the notes to our consolidated financial statements included in this prospectus, we believe the following accounting policies to be the most critical to the judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

We recognize revenues in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104). SAB 104 requires that four basic criteria must be met prior to revenue recognition: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or the services have been rendered, (iii) the fee is fixed and determinable, and (iv) collection of the resulting receivable is reasonably assured.

We generate revenues by providing access to our online database or delivering information obtained from our database, usually in the form of periodic reports. Revenues are typically recognized on a straight-line basis over the period in which access to data or reports are provided, which generally ranges from three to 24 months.

We also generate revenues through survey services under contracts ranging in term from two months to one year. Our survey services consist of survey and questionnaire design with subsequent data collection, analysis and reporting. We recognize revenues on a straight-line basis over the estimated data collection period once the survey or questionnaire design has been delivered. Any change in the estimated data collection period results in an adjustment to revenues recognized in future periods.

Certain of our arrangements contain multiple elements, consisting of the various services we offer. Multiple element arrangements typically consist of a subscription to our online database combined with periodic reports of customized data. These arrangements are accounted for in accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables.* We have determined that there is not objective and reliable evidence of fair value for any of our services and, therefore, account for all elements in multiple elements arrangements as a single unit of accounting. Access to data under the subscription element is generally provided shortly after the execution of the contract. However, the initial delivery of periodic reports of customized data generally occurs after the data has been accumulated for a specified period subsequent to contract execution, usually one calendar quarter. We recognize the entire arrangement fee over the performance period of the last deliverable. As a result, the total arrangement fee is recognized on a straight-line basis commencing upon the delivery of the first report of customized data over the period such reports are delivered.

Generally, our contracts are non-refundable and non-cancelable. In the event a portion of a contract is refundable, revenue recognition is delayed until the refund provisions lapse. A limited number of customers have the right to cancel their contracts by providing us with written notice of cancellation. In the event that a customer cancels its contract, it is not entitled to a refund for prior services, and it will be charged for costs incurred plus services performed up to the cancellation date.

Advance payments are recorded as deferred revenues until services are delivered or obligations are met and revenue can be recognized. Deferred revenues represent the excess of amounts invoiced over amounts recognized as revenues.

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Goodwill and Intangible Assets

We record goodwill and intangible assets when we acquire other businesses. The allocation of acquisition costs to intangible assets and goodwill involves the extensive use of management s estimates and assumptions, and the result of the allocation process can have a significant impact on our future operating results. We estimate the fair value of identifiable intangible assets acquired using several different valuation approaches, including the replacement cost, income and market approaches. The replacement cost approach is based on determining the discrete cost of replacing or reproducing a specific asset. We generally use the replacement cost approach for estimating the value of acquired technology/methodology assets. The income approach converts the anticipated economic benefits that we assume will be realized from a given asset into value. Under this approach, value is measured as the present worth of anticipated future net cash flows generated by an asset. We generally use the income approach to value customer relationship assets and non-compete agreements. The market approach compares the acquired asset to similar assets that have been sold. We generally use the market approach to value trademarks and brand assets.

Under Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), intangible assets with finite lives are amortized over their useful lives while goodwill and indefinite lived assets are not amortized, but rather are periodically tested for impairment. An impairment review generally requires developing assumptions and projections regarding our operating performance. In accordance with SFAS 142, we have determined that all of our goodwill is associated with one reporting unit as we do not operate separate lines of business with respect to our services. Accordingly, on an annual basis we perform the impairment assessment for goodwill required under SFAS 142 at the enterprise level by comparing the fair value of a reporting unit, based on estimated future cash flow, to its carrying value including goodwill recorded by the reporting unit. If the carrying value exceeds the fair value, impairment is measured by comparing the derived fair value of the goodwill to its carrying value and any impairment determined is recorded in the current period. If our estimates or the related assumptions change in the future, we may be required to record impairment charges to reduce the carrying value of these assets, which could be material.

Long-lived assets

Our long-lived assets primarily consist of property and equipment and intangible assets. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we evaluate the recoverability of our long-lived assets for impairment whenever events or changes in circumstances indicate the carrying value of such assets may not be recoverable. If an indication of impairment is present, we compare the estimated undiscounted future cash flows to be generated by the asset to its carrying amount. If the undiscounted future cash flows are less than the carrying amount of the asset, we record an impairment loss equal to the excess of the asset s carrying amount over its fair value. The fair value is determined based on valuation techniques such as a comparison to fair values of similar assets or using a discounted cash flow analysis. Substantially all of our long-lived assets are located in the United States. Although we believe that the carrying values of our long-lived assets are appropriately stated, changes in strategy or market conditions or significant technological developments could significantly impact these judgments and require adjustments to recorded asset balances. There were no impairment charges recognized during the years ended December 31, 2004, 2005, or 2006.

Allowance for Doubtful Accounts

We manage credit risk on accounts receivable by performing credit evaluations of our customers on a selective basis, by reviewing our accounts and contracts and by providing appropriate allowances for uncollectible amounts. Allowances are based on management s judgment, which considers historical experience and specific knowledge of accounts that may not be collectible. We make provisions based on our historical bad debt experience, a specific review of all significant outstanding invoices and an assessment of general economic conditions. If the financial condition of a customer deteriorates, resulting in an impairment of its ability to make payments, additional allowances may be required.

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Income Taxes

We account for income taxes using the liability method in accordance with SFAS No. 109, *Accounting for Income Taxes.* We estimate our tax liability through calculations we perform for the determination of our current tax liability, together with assessing temporary differences resulting from the different treatment of items for income tax and financial reporting purposes. These differences result in deferred tax assets and liabilities, which are recorded on our balance sheet. Management then assesses the likelihood that deferred tax assets will be recovered in future periods. In assessing the need for a valuation allowance against the net deferred tax asset, we consider factors such as future reversals of existing taxable temporary differences, taxable income in prior carryback years, if carryback is permitted under the tax law, tax planning strategies and future taxable income exclusive of reversing temporary differences and carryforwards. To the extent that we cannot conclude that it is more likely than not that the benefit of such assets will be realized, we establish a valuation allowance to adjust the net carrying value of such assets.

To date, we have recorded a full valuation allowance against our gross deferred tax assets, principally net operating loss carryforwards, due to uncertainty regarding our ability to generate future taxable income. Any deferred tax benefit or provision to date has been offset by changes in the valuation allowance against our deferred tax assets. To the extent we determine that all or a portion of our valuation allowance is no longer necessary, we will recognize an income tax benefit in the period such determination is made for the reversal of the valuation allowance. Once the valuation allowance is eliminated, its reversal will no longer be available to offset our current tax provision. These events could have a material impact on our reported results of operations.

As of December 31, 2006, we had $81.2 million of both federal and state net operating loss carryforwards which begin to expire in 2020 for federal and begin to expire in 2010 for state income tax reporting purposes. In addition, we had net operating loss carryforwards related to our foreign subsidiaries totaling $966,000 as of December 31, 2005 and $703,000 as of December 31, 2006, which begin to expire in 2010. Approximately $13.3 million of our net operating loss carryforwards are subject to annual limitations under Section 382 of the Internal Revenue Code based on changes in percentage of our ownership. We do not expect that this limitation will impact our ability to utilize all of our net operating losses prior to their expiration.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS No. 109. This interpretation clarifies the accounting for income taxes by prescribing that a company should use a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax provisions that meet the more-likely-than-not recognition threshold should be measured as the largest amount of tax benefits, determined on a cumulative probability basis, which is more likely than not to be realized upon ultimate settlement in the financial statements. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition, and explicitly excludes income taxes from the scope of SFAS No. 5, *Accounting for Contingencies.* FIN 48 is effective for fiscal years beginning after December 15, 2006, and was adopted by us on January 1, 2007. As of the adoption date of FIN 48 of January 1, 2007 and March 31, 2007, we do not have any material gross unrecognized tax benefits. We or one of our subsidiaries files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. For income tax returns filed by us, we are no longer subject to U.S. federal, state and local tax examinations by tax authorities for years before 2002, although carryforward tax attributes that were generated prior to 2002 may still be adjusted upon examination by tax authorities if they either have been or will be utilized. It is our policy to recognize interest and penalties related to income tax matters in income tax expense.

Stock-Based Compensation

Through December 31, 2005, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), we applied the intrinsic value method for accounting for stock-based compensation as set forth in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). For purposes of the pro forma disclosures required under SFAS 123, we used the minimum-value method to estimate the fair value of our stock-based awards. On January 1, 2006, we adopted SFAS No. 123R, *Share-*

Based Compensation (SFAS 123R). Under SFAS 123R, a non-public company that previously used the minimum value method for pro forma disclosure purposes is required to adopt the standard using the prospective method. Under the prospective method, all awards granted, modified or settled after the date of adoption are accounted for using the measurement, recognition and attribution provisions of SFAS 123R. As a result, stock-based awards granted prior to the date of adoption of SFAS 123R will continue to be accounted for under APB 25 with no recognition of stock-based compensation in future periods, unless such awards are modified or settled.

Subsequent to the adoption of SFAS 123R, we estimate the fair value of our stock-based awards on the date of grant using the Black-Scholes option-pricing model. The determination of fair value using the Black-Scholes model requires a number of complex and subjective variables. One key input into the model is the estimated fair value of our common stock on the date of grant. Our board of directors has estimated the fair value of our common stock for the purpose of determining stock-based compensation expense. Our board utilized valuation methodologies commonly used in the valuation of private company equity securities for purposes of estimating the fair value of our common stock.

Other key variables in the Black-Scholes option-pricing model include the expected volatility of our common stock price, the expected term of the award and the risk-free interest rate. In addition, under SFAS 123R, we are required to estimate forfeitures of unvested awards when recognizing compensation expense. If factors change and we employ different assumptions in the application of SFAS 123R in future periods, the compensation expense we record may differ significantly from what we have recorded during 2006.

At March 31, 2007, total estimated unrecognized compensation expense related to unvested stock-based awards granted prior to that date was $6.6 million, which is expected to be recognized over a weighted-average period of 2.39 years.

We expect stock-based compensation expense to increase in absolute dollars as a result of the adoption of SFAS 123R as options that were granted at the beginning of 2006 and beyond vest. Beginning in 2007, we expect to make use of restricted stock awards and reduce our use of stock options as a form of stock-based compensation. The actual amount of stock-based compensation expense we record in any fiscal period will depend on a number of factors, including the number of shares subject to the stock options issued, the fair value of our common stock at the time of issuance and the expected volatility of our stock price over time.

Estimation of Fair Value of Warrants to Purchase Redeemable Convertible Preferred Stock

On July 1, 2005, we adopted FASB Staff Position 150-5 (FSP 150-5). Our outstanding warrants to purchase shares of our redeemable convertible preferred stock are subject to the requirements in FSP 150-5, which require us to classify these warrants as current liabilities and to adjust the value of these warrants to their fair value at the end of each reporting period. At the time of adoption, we recorded $440,000 for the cumulative effect of this change in accounting principle to reflect the cumulative change in estimated fair value of these warrants as of that date. We recorded $14,000 and $224,000 for the years ended December 31, 2005 and 2006, respectively, to reflect increases in the estimated fair value of the warrants. We recorded a decrease in the estimated fair value of the warrants during the three months ended March 31, 2007 of $11,000. We estimated the fair value of these warrants at the respective dates using the Black-Scholes option valuation model, based on the estimated market value of the underlying redeemable convertible preferred stock at the valuation measurement date, the contractual term of the warrant, risk-free interest rates and expected dividends on and expected volatility of the price of the underlying redeemable convertible preferred stock. These estimates, especially the market value of the underlying redeemable convertible preferred stock and the expected volatility, are highly judgmental and could differ materially in the future.

Upon the closing of this offering, all outstanding warrants to purchase shares of our preferred stock will become warrants to purchase shares of our common stock and, as a result, will no longer be subject to FSP 150-5. The then-current aggregate fair value of these warrants will be reclassified from liabilities to additional paid-in capital, a component of stockholder s equity, and we will cease to record any related periodic fair

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value adjustments. We anticipate that we will incur a non-cash charge relating to our outstanding warrants for preferred stock in the period in which this offering closes. Assuming that the price at which our common stock is valued for these purposes is the initial public offering price of $ per share, the amount of that charge would be approximately $. The exact amount of the charge may depend on the closing trading price of our common stock on The NASDAQ Global Market on , the expected date of the closing of this offering.

Seasonality

Historically, a slightly higher percentage of our customers have renewed their subscription products with us toward the end of the fourth quarter. While we execute projects for our customers throughout the year, we have historically experienced a slight upturn in our project-based business in the fourth quarter.

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Results of Operations

The following table sets forth selected consolidated statements of operations data as a percentage of total revenues for each of the periods indicated.

	Year Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
Revenues	100.0%	100.0%	100.0%	100.0%	100%
Cost of revenues	37.7	36.2	31.0	34.4	28.8
Selling and marketing	39.8	37.7	32.4	35.7	34.5
Research and development	15.7	14.8	13.6	14.3	13.7
General and administrative	14.3	14.1	12.5	12.8	13.4
Amortization	1.0	4.8	2.1	2.5	1.6
Total expenses from operations	108.5	107.7	91.6	99.6	92.0
(Loss) income from operations	(8.5)	(7.7)	8.4	0.4	8.0
Interest (expense) income, net	(0.7)	(0.4)	0.3	0.1	0.5
(Loss) gain from foreign currency		(0.2)	0.2		
Revaluation of preferred stock warrant liabilities			(0.3)		0.1
(Loss) income before income taxes and cumulative effect of change in accounting principle	(9.2)	(8.3)	8.6	0.6	8.5
(Benefit) provision for income taxes		(0.4)	0.1		0.2
Net (loss) income before cumulative effect of change in accounting principle	(9.2)	(7.9)	8.6	0.6	8.2
Cumulative effect of change in accounting principle		(0.9)			
Net (loss) income	(9.2)	(8.8)	8.6	0.6	8.2
Accretion of redeemable preferred stock	(6.1)	(5.2)	(4.8)	(5.0)	(4.7)
Net (loss) income attributable to common stockholders	(15.4)%	(14.0)%	3.8%	(4.4)%	3.5%

Three Months Ended March 31, 2006 and 2007

Revenues

	Three Months Ended March 31, 2006	2007	Change	Percent Change
	(Dollars in thousands)			
Total revenues	$ 14,985	$ 18,681	$ 3,696	24.7%

Total revenues increased by approximately $3.7 million for the three months ended March 31, 2007 as compared to the three months ended March 31, 2006. This increase was primarily due to increased sales to existing customers based in the U.S. totaling $14.6 million in the first three months of 2007, which was $2.3 million higher than in the first three months of 2006. In addition, revenues in the first three months of 2007 from new U.S. customers were $2.3 million, an increase of approximately $707,000 as compared to the first three months of 2006. Revenues from customers outside of the U.S. totaled approximately $1.8 million, or approximately 10% of total revenues, in the first three months of 2007, which was an increase of $670,000 as compared to the first three months of 2006. This increase in the first three months of 2007 was due primarily to our ongoing expansion efforts in Europe, plus continued growth in Canada. We also experienced revenue growth due to general increases in our price levels in the first three months of 2007 as compared to the first three months of 2006.

Our total customer base grew during the first three months of 2007 by a net increase of 37 customers to a total of 743 customers as of March 31, 2007 compared to 706 customers as of December 31, 2006. There was continued revenue growth in both our subscription revenues, which increased by approximately $3.6 million

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from $10.9 million in the first three months of 2006 to $14.5 million in the first three months of 2007, and, to a lesser extent our project-based revenues, which increased by $100,000 from $4.1 million in the first three months of 2006 to $4.2 million in the first three months of 2007.

Cost of Revenues

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007	Change	Percent Change
	(dollars in thousands)			
Cost of revenues	$ 5,148	$ 5,388	$ 240	4.7%
As a percentage of revenues	34.4%	28.8%		

Cost of revenues consists primarily of expenses related to operating our network infrastructure and the recruitment, maintenance and support of our consumer panels. Expenses associated with these areas include the salaries and related expenses of network operations, survey operations, custom analytics and technical support, all of which are expensed as they are incurred. Cost of revenues also includes data collection costs for our products and operational costs associated with our data centers, including depreciation expense associated with computer equipment.

Cost of revenues increased in the three months ending March 31, 2007 as compared to the three months ending March 31, 2006, primarily due to increased salaries and related costs associated with supporting our consumer panel and data centers. Our data center costs increased as a result of the relocation in June 2006 of our Illinois data center to a new service provider and increased utility costs at our Virginia data center. Cost of revenues declined as a percentage of revenues by 5.6% over the same period primarily due to the increases in revenues as described above and a moderation of the increases in costs to build and maintain our panel. In addition, the headcount and costs associated with our technology staff grew at a lower rate than our growth in revenues. The decline in cost of revenues as a percentage of revenues was offset in part by increases in bandwidth costs, which grew approximately $91,000 from the prior period, an increase of approximately 16%.

We expect cost of revenues to increase in absolute dollar amounts as we seek to grow our business but vary as a percentage of revenues depending on whether we benefit from investments in our panel and network infrastructure.

Selling and Marketing Expenses

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007	Change	Percent Change
	(Dollars in thousands)			
Selling and marketing expenses	$ 5,345	$ 6,451	$ 1,106	20.7%
As a percentage of revenues	35.7%	34.5%		

Selling and marketing expenses consist primarily of salaries, benefits, commissions and bonuses paid to our direct sales force and industry analysts, as well as costs related to online and offline advertising, product management, industry conferences, promotional materials, public relations, other sales and marketing programs, and allocated overhead, including rent and depreciation. All selling and marketing costs are expensed as they are incurred.

Commission plans are developed for our account managers with criteria and size of sales quotas that vary depending upon the individual s role. Commissions are paid to a salesperson and are expensed as selling and marketing costs when a sales contract is executed by both the customer and comScore. In the case of multi-year agreements, one year of commissions is paid initially, with the remaining amounts paid at the beginning of the succeeding years.

Selling and marketing expenses increased in the three months ending March 31, 2007 as compared to the three months ending March 31, 2006 primarily due to increased employee salaries and benefits and related costs associated with an increase in account management personnel for our sales force, the formation of our product management team and an increase in commission costs associated with increased revenues. Our selling and marketing headcount increased by approximately 40 employees to 170 employees as of March 31, 2007. In addition, we experienced an increase in recruiting and relocation fees associated with the hiring of additional personnel and an increase in advertising costs. Sales and marketing expenses as a percentage of revenues during this period reflect the increased productivity of our direct sales force.

We expect selling and marketing expenses to increase in absolute dollar amounts as we continue to grow our selling and marketing efforts but to vary in future periods as a percentage of revenues depending on whether we benefit from increased productivity in our sales force and from increased revenues resulting in part from our ongoing marketing initiatives.

Research and Development Expenses

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007	Change	Percent Change
	(Dollars in thousands)			
Research and development expenses	$ 2,137	$ 2,556	$ 419	19.6%
As a percentage of revenues	14.3%	13.7%		

Research and development expenses include new product development costs, consisting primarily of compensation and related costs for personnel associated with research and development activities, and allocated overhead, including rent and depreciation.

Research and development expenses increased in the three months ended March 31, 2007 as compared to the three months ended March 31, 2006 primarily due to an increased headcount and our continued focus on developing new products, such as World Metrix, Video Metrix, Campaign Metrix and Ad Metrix. Research and development costs decreased slightly as a percentage of revenues, primarily due to our growth in revenues outpacing our existing investments in research and development. We also experienced an increase in costs paid to outsourced services to support our development of new products.

We expect research and development expenses to increase in absolute dollar amounts as we continue to enhance and expand our product offerings. As a result of the size and diversity of our panel and our historical investment in our technology infrastructure, we expect that we will be able to develop new products with moderate increases in research and development spending as compared to our growth in revenues. We also expect research and development expenses to moderate due to our decision to outsource certain software development activities in 2005.

General and Administrative Expenses

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007	Change	Percent Change
	(Dollars in thousands)			
General and administrative expenses	$ 1,918	$ 2,507	$ 589	30.7%
As a percentage of revenues	12.8%	13.4%		

General and administrative expenses consist primarily of salaries and related expenses for executive management, finance, accounting, human capital, legal, information technology and other administrative functions, as well as professional fees, overhead, including allocated rent and depreciation, and expenses incurred for other general corporate purposes.

General and administrative expenses increased in the three months ending March 31, 2007 as compared to the three months ending March 31, 2006, primarily due to increased professional fees and expanding our finance department. General and administrative expenses also increased to a lesser extent due to our investment to support further revenue growth.

We expect general and administrative expenses to increase on an absolute basis in future annual periods as we incur increased costs associated with being a public company. Operating as a public company will present additional management and reporting requirements that will significantly increase our directors and officers liability insurance premiums and professional fees both in absolute dollars and as a percentage of revenues. We also anticipate hiring additional personnel to help manage future growth and our operations as a public company.

Amortization Expense

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007	Change	Percent Change
	(Dollars in thousands)			
Amortization expense	$ 371	$ 293	$ (78)	(21.0)%
As a percentage of revenues	2.5%	1.6%		

Amortization expense consists of charges related to the amortization of intangible assets associated with past acquisitions.

Amortization expense decreased in the three months ended March 31, 2007 over the three months ended March 31, 2006 because certain intangible assets related to previous acquisitions were fully amortized during 2006.

Absent additional acquisitions, we expect amortization expense to continue to decline as the remaining amount of intangible assets related to previous acquisitions is amortized.

Interest (Expense) Income, Net

Interest income consists primarily of interest earned from short-term investments, such as auction rate securities, and our cash and cash equivalent balances. Interest expense is incurred due to capital leases pursuant to several equipment loan and security agreements and a line of credit that we have entered into in order to finance the lease of various hardware and other equipment purchases. Our capital lease obligations are secured by a senior security interest in eligible equipment.

Interest (expense) income, net was $11,000 and $97,000 for the three months ended March 31, 2006 and 2007, respectively. The quarterly change from 2006 to 2007 reflects the net effect of interest income that we earned on our cash balances offset by the interest expense associated with the capital leases that we had in place in each period. Our cash, cash equivalents and short-term investments balance increased by $2.1 million in the first quarter of 2007. We also continued to reduce the outstanding balance on our outstanding capital lease obligations.

(Loss) Gain from Foreign Currency

Our gains and losses from foreign currency transactions arise from our Canadian and United Kingdom foreign subsidiaries that hold cash and receivables in currencies other than their functional currency. During the three months ended March 31, 2007 we recorded a loss of $8,000 compared to a gain of $6,000 in the three month period ended March 31, 2006. Our foreign currency transactions are recorded as a result of fluctuations in the exchange rate between the U.S. dollar and the Canadian dollar, Euro and British Pound.

Provision for Income Taxes

As of March 31, 2007, we had net operating loss carryforwards for federal income tax purposes in the amount of approximately $78.9 million, which begin to expire in 2020 for federal and begin to expire in 2010 for state income tax reporting purposes. In the future, we intend to utilize any carryforwards available to us to reduce our tax payments. Approximately $13.3 million of our net operating loss carryforwards are subject to annual limitations under Section 382 of the Internal Revenue Code based on changes in percentage of our ownership. We do not expect that this limitation will impact our ability to utilize all of our net operating losses prior to their expiration. During the three months ended March 31, 2007, we recorded an income tax provision of $46,000 as compared to no provision recorded during the three months ended March 31, 2006. The tax provision is comprised of an income tax expense of $65,000 reflecting our alternative minimum tax and is partly offset by a decrease of $19,000 in the deferred tax liability associated with a temporary difference related to certain acquired intangible assets of SurveySite.

Years Ended December 31, 2004, 2005 and 2006

Revenues

	Year Ended December 31,			Increase		Percent Change	
				2004 v.	2005 v.	2004 v.	2005 v.
	2004	2005	2006	2005	2006	2005	2006
	(Dollars in thousands)						
Total revenues	$ 34,894	$ 50,267	$ 66,293	$ 15,373	$ 16,026	44.1%	31.9%

Total revenues increased by approximately $16.0 million for the year ended December 31, 2006 as compared to the year ended December 31, 2005. This increase was primarily due to increased sales to existing customers based in the U.S. totaling $52.9 million in 2006, or $12.5 million higher than in 2005. In addition, revenues in 2006 from new U.S. customers were $7.7 million, an increase of $1.2 million compared to 2005. Revenues from customers outside of the U.S. totaled approximately $5.7 million, or approximately 9% of total revenues, in 2006, representing an increase of $2.3 million compared to 2005. This increase in 2006 was due primarily to our ongoing expansion efforts in Europe, which included the opening of an office in London in the first half of 2005, plus continued growth in Canada. We also experienced revenue growth due to general increases in our price levels in 2006 as compared to 2005.

Our total customer base grew during this period from 565 as of December 31, 2005 to 706 as of December 31, 2006. There was continued revenue growth in both our subscription revenues, which increased by approximately $14.6 million from 2005 to 2006, and our project-based revenues, which increased by $1.4 million from 2005 to 2006.

In 2005, total revenues increased approximately $15.4 million over 2004 revenues. This growth was principally driven by increased sales to existing U.S. customers of $40.4 million, an increase of $11.2 million over 2004. Further, revenues from new customers based in the U.S. were $6.5 million, which was a $2.6 million increase over 2004. Revenues from customers outside of the U.S. totaled $3.4 million, or approximately 7% of revenues, in 2005. This represented an increase of $1.6 million over 2004, when international revenues were $1.8 million, or 5% of total revenues. We also experienced revenue growth due to general increases in our price levels in 2005 compared to 2004.

Our total customer base grew during this period from 469 as of December 31, 2004 to 565 as of December 31, 2005. During this period, our subscription revenues increased by approximately $8.0 million from 2004 to 2005, while project-based revenues increased by approximately $7.4 million. Our 2005 revenues were positively impacted by the acquisitions of SurveySite and Q2. SurveySite, which we acquired on January 4, 2005, contributed $5.1 million in revenues in 2005. Q2, which we acquired on July 28, 2004, contributed $3.6 million in revenues in 2005 as compared to $1.5 million in revenues in 2004.

We generally invoice customers on an annual, quarterly or monthly basis, or at the completion of certain milestones, in advance of revenues being recognized. Amounts that have been invoiced are recorded in accounts receivable and any unearned revenues are recorded in deferred revenues until the invoice has been collected and the revenue recognized. As a result of the increased revenues in 2006 as compared to 2005, we experienced an increase in our cash, cash equivalents and short-term investments of $6.9 million, accounts receivable increased $3.8 million and deferred revenues increased by $3.2 million. In 2005 as compared to 2004, we experienced an increase in our cash, cash equivalents and short-term investments of $770,000, an increase in accounts receivables of $4.1 million and an increase in deferred revenues of $7.1 million.

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Cost of Revenues

	Year Ended December 31,			Increase		Percent Change	
				2004 v.	2005 v.	2004 v.	2005 v.
	2004	2005	2006	2005	2006	2005	2006
	(Dollars in thousands)						
Cost of revenues	$ 13,153	$ 18,218	$ 20,560	$ 5,065	$ 2,342	38.5%	12.9%
As a percentage of revenues	37.7%	36.2%	31.0%				

Cost of revenues consists primarily of expenses related to operating our network infrastructure and the recruitment, maintenance and support of our consumer panels. Expenses associated with these areas include the salaries and related expenses of network operations, survey operations, custom analytics and technical support, all of which are expensed as they are incurred. Cost of revenues also includes data collection costs for our products and operational costs associated with our data centers, including depreciation expense associated with computer equipment.

Cost of revenues increased in 2006 as compared to 2005, primarily due to increased costs associated with supporting our consumer panel and data centers. Our panel costs increased in large part due to increased recruiting costs per panelist reflecting the impact of higher growth in online advertising and advertising rates. Our data center costs increased as a result of the relocation in 2006 of our Illinois data center to a new service provider and increased utility costs at our Virginia data center. Cost of revenues declined as a percentage of revenues over the same periods primarily due to the increases in revenues as described above and a moderation of the increases in costs to build and maintain our panel. The decline in cost of revenues as a percentage of revenues was offset in part by increases in bandwidth and data costs, which grew 9%. The headcount and costs associated with our technology staff grew at a lower rate than our growth in revenues.

Cost of revenues increased in 2005 as compared to 2004 primarily due to our acquisition of SurveySite and higher costs associated with data center operations and employee salaries, benefits and related costs required to support growth in our revenues and customer base during 2005. The cost of revenues as a percentage of revenues declined in 2005 compared to 2004 primarily due to the increases in revenues as described above as well as relatively flat panel costs and smaller increases in bandwidth and data center costs, which did not grow at the same rate as our customer base and revenues. The headcount and costs associated with our technology staff grew at a lower rate than our growth in revenues.

Selling and Marketing Expenses

	Year Ended December 31,			Increase		Percent Change	
				2004 v.	2005 v.	2004 v.	2005 v.
	2004	2005	2006	2005	2006	2005	2006
	(Dollars in thousands)						
Selling and marketing expenses	$ 13,890	$ 18,953	$ 21,473	$ 5,063	$ 2,520	36.5%	13.3%
As a percentage of revenues	39.8%	37.7%	32.4%				

Selling and marketing expenses consist primarily of salaries, benefits, commissions and bonuses paid to our direct sales force and industry analysts, as well as costs related to online and offline advertising, product management, industry conferences, promotional materials, public relations, other sales and marketing programs, and allocated overhead, including rent and depreciation. All selling and marketing costs are expensed as they are incurred. Commission plans are developed for our account managers with criteria and size of sales quotas that vary depending upon the individual s role. Commissions are paid to a salesperson and are expensed as selling and marketing costs when a sales contract is executed by both the customer and comScore. In the case of multi-year agreements, one year of commissions is paid initially, with the remaining amounts paid at the beginning of the succeeding years.

Selling and marketing expenses increased in 2006 as compared to 2005 in absolute dollars, primarily due to increased employee salaries and benefits and related costs resulting from additional account management personnel in our sales force, plus an increase in commission costs associated with increased revenues. Our selling and marketing headcount increased from 143 employees as of December 31, 2005 to 155 employees as of December 31, 2006. In addition, the expansion of our European office in London and increased marketing efforts in Europe contributed to our increase in selling and marketing expenses and headcount in 2006. The decrease in selling and marketing expenses as a percentage of revenues during this period reflects the increased productivity of our direct sales force and an increase in revenues.

Selling and marketing expenses increased in 2005 as compared to 2004, primarily due to an increase in the number of account managers, higher commissions associated with our growth in revenues and an increase in online and offline advertising and promotional efforts in support of building our brands. In addition, our selling and marketing headcount increased from 77 employees as of December 31, 2004 to 143 employees as of December 31, 2005. The acquisition of SurveySite and the opening of our first European office in London also contributed to our increase in selling and marketing expenses and headcount in 2005. The decrease in selling and marketing expenses as a percentage of revenues during this period reflected the increased productivity of our direct sales force.

Research and Development Expenses

	Year Ended December 31,			Increase		Percent Change	
	2004	2005	2006	2004 v. 2005	2005 v. 2006	2004 v. 2005	2005 v. 2006
	(Dollars in thousands)						
Research and development expenses	$ 5,493	$ 7,416	$ 9,009	$ 1,923	$ 1,593	35.0%	21.5%
As a percentage of revenues	15.7%	14.8%	13.6%				

Research and development expenses include new product development costs, consisting primarily of compensation and related costs for personnel associated with research and development activities, and allocated overhead, including rent and depreciation.

Research and development expenses increased in 2006 as compared to 2005 primarily due to increased headcount and our continued focus on developing new products, such as World Metrix, Video Metrix, Campaign Metrix and Ad Metrix. Research and development costs decreased slightly as a percentage of revenues, primarily due to our growth in revenues.

The increase in research and development expenses in 2005 compared to 2004 was due to new product development activity, including the launch of a streaming media audience measurement product. The acquisition and integration of SurveySite s operations also contributed to the absolute dollar increase in research and development costs during this period.

General and Administrative Expenses

	Year Ended December 31,			Increase		Percent Change	
	2004	2005	2006	2004 v. 2005	2005 v. 2006	2004 v. 2005	2005 v. 2006
	(Dollars in thousands)						

General and administrative expenses	$ 4,982	$ 7,089	$ 8,293	$ 2,107	$ 1,204	42.3%	17.0%
As a percentage of revenues	14.3%	14.1%	12.5%				

General and administrative expenses consist primarily of salaries and related expenses for executive management, finance, accounting, human capital, legal, information technology and other administrative functions, as well as professional fees, overhead, including allocated rent and depreciation, and expenses incurred for other general corporate purposes.

General and administrative expenses increased in 2006 as compared to 2005, primarily due to increased professional fees and expanding our finance department. As a percentage of revenues, general and administrative expenses decreased in 2006 as compared to 2005, due primarily to our growth in revenues.

General and administrative expenses increased in 2005 as compared to 2004, primarily due to higher salaries, benefits and related costs associated with our existing employees plus an increase in our general and administrative headcount from 14 employees as of December 31, 2004 to 27 employees as of December 31, 2005. The higher headcount was due primarily to an increase in employees in such functions as finance, accounting, human capital and legal, as we built our staff and infrastructure to support our growth. Our acquisition of SurveySite also contributed to the increase in general and administrative expenses and related headcount in 2005. On a percentage of revenues basis, general and administrative expenses were flat in 2005 as compared to 2004, as the increase in headcount related to broadening our administrative support capabilities and the acquisition of SurveySite was offset by the growth in our customer base and revenues.

Amortization Expense

	Year Ended December 31,			Increase		Percent Change	
	2004	2005	2006	2004 v. 2005	2005 v. 2006	2004 v. 2005	2005 v. 2006
	(Dollars in thousands)						
Amortization expense	$ 356	$ 2,437	$ 1,371	$ 2,081	$ (1,066)	584.6%	(43.7)%
As a percentage of revenues	1.0%	4.8%	2.1%				

Amortization expense consists of charges related to the amortization of intangible assets associated with past acquisitions.

Amortization expense decreased during fiscal year 2006 over 2005 because certain intangible assets related to previous acquisitions were fully amortized as of that period.

The increase in amortization expense from 2004 to 2005 in absolute dollars is attributable primarily to the amortization expense relating to the Q2 acquisition on July 28, 2004 and the SurveySite acquisition on January 4, 2005.

Interest (Expense) Income, Net

Interest income consists primarily of interest earned from short-term investments, such as auction rate securities, and our cash and cash equivalent balances. Interest expense is incurred due to capital leases pursuant to several equipment loan and security agreements and a line of credit that we have entered into in order to finance the lease of various hardware and other equipment purchases. Our capital lease obligations are secured by a senior security interest in eligible equipment.

Interest (expense) income, net was $(246,000) in 2004, $(208,000) in 2005 and $231,000 in 2006. The year-to-year change from 2004 to 2005 and from 2005 to 2006 primarily reflects the net effect of interest income that we earned on our cash balances offset by the interest expense associated with the capital leases that we had in place in each year. Our net interest expense decreased from 2004 to 2005 due to our larger cash and investments balances and the lower amounts outstanding under our capital leases. We reported net interest income in 2006 due to a $6.9 million increase in our cash and investments balance. We also continued to reduce the outstanding balance on our outstanding capital lease obligations.

(Loss) Gain from Foreign Currency Transactions

Our gains and losses from foreign currency transactions arise from our Canadian and United Kingdom foreign subsidiaries that hold cash and receivables in currencies other than their functional currency. Our loss on foreign currency transactions in 2005 was $96,000. We recorded a gain of $125,000 in 2006 as a result of fluctuations in the exchange rate between the U.S. dollar and the Canadian dollar, Euro and British Pound.

Provision for Income Taxes

As of December 31, 2006, we had net operating loss carryforwards for federal income tax purposes in the amount of approximately $81.2 million, which begin to expire in 2020 for federal and begin to expire in 2010 for state income tax reporting purposes. In the future, we intend to utilize any carryforwards available to us to reduce our tax payments. Approximately $13.3 million of the net operating loss carryforwards are subject to

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annual limitations under Section 382 of the Internal Revenue Code based on changes in percentage of our ownership. We do not expect that this limitation will impact our ability to utilize all of our net operating losses prior to their expiration. In 2005, we had an income tax benefit of $182,000 related to a deferred tax liability of $356,000 associated with a temporary difference related to certain acquired intangible assets of SurveySite. This compares to an income tax expense of $50,000 in 2006 reflecting a payment of alternative minimum tax (AMT) partly offset by a decrease in the deferred tax liability.

Quarterly Results of Operations

The following tables set forth selected unaudited quarterly consolidated statement of operations data for each of the quarters indicated. The consolidated financial statements for each of these quarters have been prepared on the same basis as the audited consolidated financial statements included in this prospectus and, in the opinion of management, include all adjustments necessary for the fair presentation of the consolidated results of operations for these periods. You should read this information together with our consolidated financial statements and related notes included elsewhere in this prospectus. These quarterly operating results are not necessarily indicative of the results for any future period.

	Three Months Ended								
	Mar. 31, 2005	**Jun. 30, 2005**	**Sept. 30, 2005**	**Dec. 31, 2005**	**Mar. 31, 2006**	**Jun. 30, 2006**	**Sept. 30, 2006**	**Dec. 31, 2006**	**Mar. 31, 2007**
	(In thousands) (Unaudited)								
Revenues	$ 11,135	$ 13,150	$ 12,953	$ 13,029	$ 14,985	$ 16,906	$ 16,165	$ 18,237	$ 18,681
Cost of revenues(1)	3,936	4,863	4,602	4,817	5,148	5,205	4,977	5,230	5,388
Selling and marketing(1)	4,234	4,813	4,821	5,085	5,345	5,323	5,171	5,634	6,451
Research and development(1)	1,678	1,876	1,908	1,954	2,137	2,258	2,273	2,341	2,556
General and administrative(1)	1,489	1,804	1,779	2,017	1,918	2,176	1,897	2,302	2,507
Amortization	621	603	612	601	371	333	333	334	293
Total expenses from operations	11,958	13,959	13,722	14,474	14,919	15,295	14,651	15,841	17,195
(Loss) income from operations	(823)	(809)	(769)	(1,445)	66	1,611	1,514	2,396	1,486
Interest (expense) income, net	(58)	(71)	(39)	(40)	11	23	84	113	97
(Loss) gain from foreign currency	(21)	(1)	(72)	(2)	6	(33)	3	149	(8)
Revaluation of preferred stock warrant liabilities			(6)	(8)	2	(211)	(6)	(9)	11
	(902)	(881)	(886)	(1,495)	85	1,390	1,595	2,649	1,586

(Loss) income before income taxes and cumulative effect of change in accounting principle									
(Benefit) provision for income taxes	(53)	(52)	(38)	(39)				50	46
Net (loss) income before cumulative effect of change in accounting principle	(849)	(829)	(848)	(1,456)	85	1,390	1,595	2,599	1,540
Cumulative effect of change in accounting principle			(440)						
Net (loss) income	(849)	(829)	(1,288)	(1,456)	85	1,390	1,595	2,599	1,540
Accretion of redeemable preferred stock	(611)	(643)	(675)	(709)	(742)	(777)	(812)	(848)	(885)
Net (loss) income attributable to common stockholders	$ (1,460)	$ (1,472)	$ (1,963)	$ (2,165)	$ (657)	$ 613	$ 783	$ 1,751	$ 655

(1) Amortization of stock-based compensation is included in the line items above as follows:

	Three Months Ended								
	Mar. 31, 2005	**Jun. 30, 2005**	**Sept. 30, 2005**	**Dec. 31, 2005**	**Mar. 31, 2006**	**Jun. 30, 2006**	**Sept. 30, 2006**	**Dec. 31, 2006**	**Mar. 31, 2007**
	(In thousands) (Unaudited)								
Cost of revenues	$	$	$	$	$	$ 2	$ 4	$ 6	$ 9
Selling and marketing					6	26	23	27	39
Research and development						2	4	7	8
General and administrative		1	1	1	1	10	40	40	51

	As a Percentage of Total Revenues Three Months Ended								
	Mar. 31, 2005	**Jun. 30, 2005**	**Sept. 30, 2005**	**Dec. 31, 2005**	**Mar. 31, 2006**	**Jun. 30, 2006**	**Sept. 30, 2006**	**Dec. 31, 2006**	**Mar. 31, 2007**
	(Unaudited)								
Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of revenues	35.3	37.0	35.5	37.0	34.4	30.8	30.8	28.7	28.8
Selling and marketing	38.0	36.6	37.2	39.0	35.7	31.5	32.0	30.9	34.5
Research and development	15.1	14.3	14.7	15.0	14.3	13.4	14.1	12.9	13.7
General and administrative	13.4	13.7	13.7	15.5	12.8	12.9	11.7	12.6	13.4
Amortization	5.6	4.6	4.7	4.6	2.5	2.0	2.1	1.8	1.6
Total expenses from operations	107.4	106.2	105.8	111.1	99.6	90.5	90.6	86.9	92.0
(Loss) income from operations	(7.4)	(6.2)	(5.8)	(11.1)	0.4	9.5	9.4	13.1	8.0
Interest (expense) income, net	(0.5)	(0.5)	(0.3)	(0.3)	0.1	0.1	0.5	0.6	0.5
(Loss) gain from foreign currency	(0.2)		(0.6)			(0.2)		0.8	
Revaluation of preferred stock warrant liabilities						(1.2)			0.1

(Loss) income before income taxes and cumulative effect of change in accounting principle	(8.1)	(6.7)	(6.8)	(11.4)	0.6	8.2	9.9	14.5	8.5
(Benefit) provision for income taxes	(0.5)	(0.4)	(0.3)	(0.3)				0.3	0.2
Net (loss) income before cumulative effect of change in accounting principle	(7.6)	(6.3)	(6.5)	(11.1)	0.6	8.2	9.9	14.3	8.2
Cumulative effect of change in accounting principle			(3.4)						
Net (loss) income	(7.6)	(6.3)	(9.9)	(11.1)	0.6	8.2	9.9	14.3	8.2
Accretion of redeemable preferred stock	(5.5)	(4.9)	(5.2)	(5.4)	(5.0)	(4.6)	(5.0)	(4.6)	(4.7)
Net (loss) income attributable to common stockholders	(13.1)	(11.2)	(15.1)	(16.6)	(4.4)	3.6	4.8	9.6	3.5%

Over the nine quarters presented in the table above, revenues have generally increased due primarily to increases in subscription revenues from existing customers, growth in our customer base (both domestically and internationally), general increases in pricing for our products and the acquisition of SurveySite. In 2005, revenues increased sequentially from the first quarter to the second quarter before declining slightly in the third quarter and remaining relatively flat in the fourth quarter. Over these quarterly periods, fluctuations in project revenues partially offset the steady growth in subscription revenues and contributed to the relatively flat revenues on a sequential basis from the second through the fourth quarters of 2005. In 2006, revenues increased significantly on a sequential basis in the first and second quarters before decreasing in the third quarter due to fluctuations in the closing of agreements relating to, and the execution of, projects. Revenues increased significantly in the fourth quarter of 2006 due to increased growth in subscription revenues for existing and new customers. Subscription revenues increased sequentially in each of the quarters presented.

Cost of revenues as a percentage of total revenues held relatively steady in each of the quarters in 2005 before declining in 2006. The decrease in cost of revenues on a percentage basis was due to the growth in revenues relative to the moderation in fixed costs to support our consumer panel, data center and technical infrastructure.

On an absolute basis, total expenses from operations increased significantly in the second quarter of 2005 due primarily to costs associated with the integration of the Q2 and SurveySite acquisitions and certain expenses for external data sources. Total expenses from operations remained relatively flat in the third quarter of 2005 and increased in the fourth quarter of 2005, primarily due to higher sales costs related to the opening of our first European sales office, located in London, and increased general and administrative costs in support of overall business growth. On an absolute basis, total expenses from operations declined slightly in the first quarter of 2006 before increasing in the second quarter of 2006, due to increases in general and administrative expenses associated with the hiring of new finance personnel and increases in professional services fees related to anticipated business expansion. In addition, expenses from operations increased in the second quarter of 2006 due to higher research and development costs tied to the development of several new products. After a decline in the third quarter, expenses from operations increased again in the fourth quarter of 2006, due to increased commissions tied to higher sales growth plus higher salaries, benefits and related costs associated with hiring additional personnel in our operations, technology, sales, research and development and general and administrative organizations to support the growth of our business. The total expenses from operations in 2006 increased at a lower rate than revenues and we were consequently able to better leverage our cost structure.

We became profitable on a net income basis in the first quarter of 2006, and were profitable on a net income basis every quarter in 2006 as our revenues increased significantly during these periods and our costs grew at a lower rate.

Liquidity and Capital Resources

The following table summarizes our cash flows:

	For the Year Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
	(In thousands)				
Consolidated Cash Flow Data:					
Net cash provided by operating activities	$ 1,907	$ 4,253	$ 10,905	$ 2,824	$ 3,156
Net cash used in investing activities	(1,332)	(2,505)	(9,573)	(2,694)	(971)
Net cash used in financing activities	(952)	(1,092)	(1,381)	(271)	(525)
Effect of exchange rate changes on cash	25	(36)	(43)	18	14
Net increase (decrease) in cash and equivalents	(352)	620	(92)	123	1,674

Since our inception, we have funded our operations and met our capital expenditure requirements primarily with venture capital and private equity funding. In five separate issuances of preferred stock, from Series A on September 27, 1999 to Series E on August 1, 2003, we have raised over $88 million from a number of institutional investors. The proceeds from all of these issuances have been used for general business purposes, with the exception of the Series E Preferred Stock offering, which was partially used to extinguish a $1.5 million bank note. Each share of preferred stock is convertible into common stock at the respective conversion ratio for each series of preferred stock at any time, subject to adjustment triggered by changes in our capitalization such as a stock split. Conversion is automatic in the event of a public offering of common stock at a price of at least $2.50 per share with gross proceeds of at least $25 million. This conversion is expected to take place upon consummation of this offering.

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Our principal uses of cash historically have consisted of payroll and other operating expenses and payments related to the purchase of equipment primarily to support our consumer panel and technical infrastructure required to support our customer base. Since the beginning of 2004, we have purchased over $4.6 million in property and equipment, made $3.9 million in principal payments on capital lease obligations, and spent $1.9 million as the cash component of consideration paid for acquisitions.

As of March 31, 2007, our principal sources of liquidity consisted of cash, cash equivalents and short-term investments of $18.2 million.

Operating Activities

Our cash flows from operating activities are significantly influenced by our investments in personnel and infrastructure to support the anticipated growth in our business, increases in the number of customers using our products and the amount and timing of payments made by these customers.

We generated approximately $3.2 million of net cash from operating activities during the three months ended March 31, 2007. The significant components of cash flows from operations were net income of $1.5 million, $1.2 million in non-cash depreciation and amortization expenses, a $2.4 million increase in amounts collected from customers in advance of when we recognize revenues as a result of our growing customer base, offset by a $843,000 increase in accounts receivable and a $1.2 million decrease in accounts payable and accrued expenses.

We generated approximately $2.8 million of net cash from operating activities during the three months ended March 31, 2006. The significant components of cash flows from operations were $1.1 million in non-cash depreciation and amortization expenses and a $2.3 million decrease in accounts receivable, offset by a $1.1 million decrease in amounts collected from customers in advance of when we recognize revenues.

We generated approximately $10.9 million of net cash from operating activities during 2006. The significant components of cash flows from operations were net income of $5.7 million, $4.3 million in non-cash depreciation and amortization expenses, a $1.4 million increase in accounts payable and accrued expenses and a $3.1 million increase in amounts collected from customers in advance of when we recognize revenues as a result of our growing customer base, offset by a $3.9 million increase in accounts receivable.

We generated $4.3 million of net cash from operating activities during 2005. The significant components of cash flows from operations were a $6.4 million increase in amounts collected from customers in advance of when we recognized revenues as a result of our growing customer base, and $5.1 million in non-cash depreciation and amortization expenses. These items were partially offset by a $3.5 million net increase in accounts receivable related to our larger customer base, a net loss of $4.4 million and other uses of cash in operations.

We generated $1.9 million of net cash from operating activities in 2004. The significant components of cash flows from operations were a $0.6 million increase in amounts collected from customers in advance of when we recognized revenues as a result of our growing customer base, a $1.7 million net increase in accounts payable and accrued expenses due to the timing of payments to our vendors when compared to the same period in 2003 and $2.7 million in non-cash depreciation and amortization expenses. These items were partially offset by a $0.7 million net increase in accounts receivable due to our larger customer base, a net loss of $3.2 million and other uses of cash in operations.

Investing Activities

Our primary investing activities have consisted of purchases of computer network equipment to support our Internet user panel and maintenance of our database, furniture and equipment to support our operations, and payments related to the acquisition of several companies. As our customer base continues to expand, we expect purchases of technical infrastructure equipment to grow in absolute dollars. The extent of these investments will be affected by our ability to expand relationships with existing customers, grow our customer base, introduce new digital formats and increase our international presence.

We used $971,000 of net cash in investing activities during the three months ended March 31, 2007, a net $475,000 of which was used to purchase short-term investments, and $494,000 of which was used to purchase property and equipment.

We used $2.7 million of net cash in investing activities during the three months ended March 31, 2006, a net $2.1 million of which was used to purchase short-term investments, $292,000 of which was used to purchase property and equipment, and $300,000 of which was used to pay contingent consideration associated with our acquisition of Q2.

We used $9.6 million of net cash in investing activities during 2006, a net $7.0 million of which was used to purchase short-term investments, $2.3 million of which was used to purchase property and equipment and $0.3 million of which was used to pay contingent considerations associated with our Q2 and SurveySite acquisitions. We used $2.5 million of net cash in investing activities during 2005, of which $1.1 million was used to purchase property and equipment, $0.9 million was used as part of the acquisition of SurveySite and $0.3 million was used to pay contingent consideration associated with the Q2 acquisition. In 2004, we used $1.3 million of net cash in investing activities, $1.2 million of which was used to purchase property and equipment and $0.9 million of which was used as part of the consideration for the acquisition of Q2, partially offset by $0.8 million in net proceeds from the sale of short-term investments.

We expect to achieve greater economies of scale and operating leverage as we expand our customer base and utilize our Internet user panel and technical infrastructure more efficiently. While we anticipate that it will be necessary for us to continue to invest in our Internet user panel, technical infrastructure and technical personnel to support the combination of an increased customer base, new products, international expansion and new digital market intelligence formats, we believe that these investment requirements will be less than the revenue growth generated by these actions. This should result in a lower rate of growth in our capital expenditures to support our technical infrastructure. In any given period, the timing of our incremental capital expenditure requirements could impact our cost of revenues, both in absolute dollars and as a percentage of revenues.

Financing Activities

Our primary financing activities since 2004 have consisted of financings to fund the acquisition of capital assets. We entered into an equipment lease agreement with GE Capital in 2003 and a line of credit agreement with GE Capital in 2005 to finance the purchase of hardware and other computer equipment to support our business growth. These borrowings were secured by a senior security interest in the equipment acquired under the facility. In December 2006, we entered into an equipment lease agreement with Banc of America Leasing & Capital, LLC to finance the purchase of new hardware and other computer equipment as we continue to expand our technology infrastructure in support of our business growth. This agreement includes a $5 million line of credit available through December 31, 2007. Through December 31, 2006, we used this credit facility to establish an equipment lease for the amount of approximately $2.9 million. The base term for this lease is three years and includes a small charge in the event of prepayment.

We used $525,000 of net cash in financing activities during the three months ended March 31, 2007. We used $665,000 to make payments on our capital lease obligations partially offset by $140,000 in proceeds from the exercise of our common stock options.

We used $271,000 of net cash in financing activities during the three months ended March 31, 2006. We used $387,000 to make payments on our capital lease obligations partially offset by $116,000 in proceeds from the exercise of our common stock options.

We used $1.4 million of net cash in financing activities during 2006. We used $1.6 million to make payments on our capital lease obligations partially offset by $241,000 in proceeds from the exercise of our common stock options.

We used $1.1 million of net cash from financing activities during 2005. We used $1.2 million to make payments on our capital lease obligations partially offset by $136,000 in proceeds from the exercise of our common stock options.

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In 2004, we used approximately $1.0 million of cash in financing activities. Substantially all of the use of this cash resulted from payments on our capital lease obligations.

We do not have any special purpose entities, and other than operating leases for office space, described below, we do not engage in off-balance sheet financing arrangements.

Contractual Obligations and Known Future Cash Requirements

Set forth below is information concerning our known contractual obligations as of December 31, 2006 that are fixed and determinable.

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
			(In thousands)		
Capital lease obligations	$ 4,418	$ 1,986	$ 2,432		
Operating lease obligations	5,058	2,009	2,063	760	226
Total	$ 9,476	$ 3,995	$ 4,495	$ 760	$ 226

Our principal lease commitments consist of obligations under leases for office space and computer and telecommunications equipment. We finance the purchase of some of our computer equipment under a capital lease arrangement over a period of 36 months. Our purchase obligations relate to outstanding orders to purchase computer equipment and are typically small; they do not materially impact our overall liquidity.

We currently have a line of credit for up to $5.0 million available to us until December 31, 2007. We have used $2.9 million of such line of credit to establish an equipment lease for the amount of approximately $2.9 million bearing interest at a rate of 7.75% per annum.

Future Capital Requirements

We believe that our existing cash, cash equivalents, and short-term investments and operating cash flow, will be sufficient to meet our projected operating and capital expenditure requirements for at least the next twelve months. In addition, we expect that the net proceeds from this offering will provide us with the financial flexibility to execute our strategic objectives, including the ability to make acquisitions and strategic investments. Our ability to generate cash, however, is subject to our performance, general economic conditions, industry trends and other factors. To the extent that funds from this offering, combined with existing cash, cash equivalents, short-term investments and operating cash flow are insufficient to fund our future activities and requirements, we may need to raise additional funds through public or private equity or debt financing. If we issue equity securities in order to raise additional funds, substantial dilution to existing stockholders may occur.

For the ninety-day period beginning July 28, 2007, the former shareholder of Q2 has the right to sell its 1,060,000 shares back to us for an aggregate price of $2.65 million, or $2.50 per share. For the ninety-day period beginning January 1, 2008, the former shareholders of SurveySite have the right to sell their 678,172 shares back to us for an aggregate price of approximately $1.8 million, or $2.67 per share.

Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. We do not hold or issue financial instruments for trading purposes or have any derivative financial instruments. To date, most payments made under our contracts are denominated in U.S. dollars and we have not experienced material gains or losses as a result of transactions denominated in foreign currencies. As of March 31, 2007, our cash reserves were maintained in money market investment accounts and fixed income securities totaling $11.5 million. These securities, like all fixed income instruments, are subject to interest rate risk and will decline in value if market interest rates increase. We have the ability to hold our fixed income investments until maturity and, therefore, we would not expect to experience any material adverse impact in income or cash flow.

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Foreign Currency Risk

A portion of our revenues is derived from transactions denominated in U.S. dollars, even though we maintain sales and business operations in foreign countries. As such, we have exposure to adverse changes in exchange rates associated with operating expenses of our foreign operations, but we believe this exposure to be immaterial at this time. As such, we do not currently engage in any transactions that hedge foreign currency exchange rate risk. As we grow our international operations, our exposure to foreign currency risk could become more significant.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. The purpose of this statement is to define fair value, establish a framework for measuring fair value and enhance disclosures about fair value measurements. The measurement and disclosure requirements are effective for us as of January 1, 2008 and are applied prospectively. We are currently evaluating the potential impact of adopting this new guidance on our results of operations and financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159), to permit all entities to choose to elect, at specified election dates, to measure eligible financial instruments at fair value. An entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date, and recognize upfront costs and fees related to those items in earnings as incurred and not deferred. SFAS No. 159 applies to fiscal years beginning after November 15, 2007, with early adoption permitted for an entity that has also elected to apply the provisions of SFAS No. 157. An entity is prohibited from retrospectively applying SFAS No. 159, unless it chooses early adoption. We are currently evaluating the impact of the provisions of SFAS No. 159 on our consolidated financial statements.

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BUSINESS

Overview

We provide a leading digital marketing intelligence platform that helps our customers make better-informed business decisions and implement more effective digital business strategies. Our products and solutions offer our customers deep insights into consumer behavior, including objective, detailed information regarding usage of their online properties and those of their competitors, coupled with information on consumer demographic characteristics, attitudes, lifestyles and offline behavior.

Our digital marketing intelligence platform is comprised of proprietary databases and a computational infrastructure that measures, analyzes and reports on digital activity. The foundation of our platform is data collected from our comScore panel of more than two million Internet users worldwide who have granted us explicit permission to confidentially measure their Internet usage patterns, online and certain offline buying behavior and other activities. By applying advanced statistical methodologies to our panel data, we project consumers online behavior for the total online population and a wide variety of user categories.

We deliver our digital marketing intelligence through our comScore Media Metrix product family and through comScore Marketing Solutions. Media Metrix delivers digital media intelligence by providing an independent, third-party measurement of the size, behavior and characteristics of Web site and online advertising network audiences among home, work and university Internet users as well as insight into the effectiveness of online advertising. Our Marketing Solutions products combine the proprietary information gathered from the comScore panel with the vertical industry expertise of comScore analysts to deliver digital marketing intelligence, including the measurement of online advertising effectiveness, customized for specific industries. We typically deliver our Media Metrix products electronically in the form of weekly, monthly or quarterly reports. Customers can access current and historical Media Metrix data and analyze these data anytime online. Our Marketing Solutions products are typically delivered on a monthly, quarterly or ad hoc basis through electronic reports and analyses.

Industry Background

Growth of Digital Commerce, Content, Advertising and Communications

The Internet is a global digital medium for commerce, content, advertising and communications. According to IDC, the number of global Internet users is projected to grow from approximately 968 million in 2005 to over 1.7 billion in 2010. As the online population continues to grow, the Internet is increasingly becoming a tool for research and commerce and for distributing and consuming media. According to IDC, the global business-to-consumer eCommerce market is projected to grow from $411 billion in 2005 to $1 trillion in 2010. According to Jupiter Research, over 80% of online users in the United States research offline purchases using the Internet, making the Internet an important channel for both online and offline merchants. Consumers are also using the Internet to access an increasing amount of digital content across media formats including video, music, text and games. According to IDC, the domestic markets for online video and music consumption are projected to reach over $1.7 billion and over $3.3 billion, respectively, in 2010.

As consumers increasingly use the Internet to research and make purchases and to consume digital media, advertisers are shifting more of their marketing budgets to digital channels. According to the Internet Advertising Bureau and PricewaterhouseCoopers, domestic online advertising spending, including search advertising, grew to $16.8 billion in 2006, an increase of 34% over 2005. Despite the size and growth of the digital marketing sector, the shift of traditional advertising spending to the Internet has yet to match the rate of consumption of online media. According to Forrester Research, digital advertising represented only 6% of the total United States advertising market in 2004 despite consumers spending 16% of their available media time online. As advertisers spend more of their marketing budgets to reach Internet users, we believe that digital marketing will continue to grow.

In addition to the growth in online commerce, content and marketing, a number of new digital technologies and devices are emerging that enable users to access content and communicate in new ways.

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Internet-enabled mobile phones allow users to access digital content such as games, music, video and news on their mobile devices through a wireless connection to the Internet. According to IDC, the worldwide number of shipments of converged mobile devices is projected to grow from 57 million in 2005 to 261 million in 2010, representing compounded annual growth of 36% over that period. Other digital communications technologies such as voice over Internet protocol (VoIP) utilize the Internet network infrastructure to enable efficient and cost-effective personal communications such as chat and VoIP-based telephony. According to Infonetics, the worldwide number of VoIP subscribers is projected to grow from 24.5 million in 2005 to 140.7 million in 2009. Delivery of digital television services over a network infrastructure using Internet Protocol, or IPTV, has a number of advantages over conventional television, including two-way communications, digital content and features, and interactivity. According to Infonetics, the worldwide number of IPTV subscribers is projected to grow from 2.4 million in 2005 to 68.9 million in 2009. We believe these and other new digital media and communications devices and services offer a similar opportunity as the Internet for us to measure and analyze user behavior.

Importance of Digital Marketing Intelligence

The interactive nature of digital media such as the Internet enables businesses to access a wealth of user information that was virtually unavailable through offline audience measurement and marketing intelligence techniques. Digital media provide businesses with the opportunity to measure detailed user activity, such as how users interact with Web page content; to assess how users respond to online marketing, such as which online ads users click on to pursue a transaction; and to analyze how audiences and user behavior compare across various Web sites. This type of detailed user data can be combined with demographic, attitudinal and transactional information to develop a deeper understanding of user behavior, attributes and preferences. Unlike offline media such as television and radio, which generally only allow for the passive measurement of relative audience size, digital media enable businesses to actively understand the link between digital content, advertising and user behavior.

We believe that the growth in the online and digital media markets for digital commerce, content, advertising and communications creates an unprecedented opportunity for businesses to acquire a deeper understanding of both their customers and their competitive market position. Businesses can use accurate, relevant and objective digital marketing intelligence to develop and validate key strategies and improve performance. For example, with a deep understanding of the size, demographic composition and other characteristics of its audience, an online content provider can better communicate the value of its audience to potential advertisers. With detailed metrics on the effectiveness of an online advertising campaign and how that campaign influences online and offline purchasing behavior, a business can refine its marketing initiatives. With insight into market share and customer behavior and preferences, a business can understand not only how its digital business is performing relative to its competitors but also the drivers behind such performance. Moreover, by using the appropriate digital marketing intelligence, businesses can refine their digital content, commerce, advertising and communications initiatives to enhance the effectiveness and return on investment of their marketing spending, enabling them to build more successful businesses.

Challenges in Providing Digital Marketing Intelligence

While the interactive and dynamic nature of digital markets creates the opportunity for businesses to gain deep insights into user behavior and competitive standing, there are a number of issues unique to the Internet that make it challenging for companies to provide digital marketing intelligence. Compared to offline media such as television or radio, the markets for digital media are significantly more fragmented, complex and dynamic. As of December 2006, we believe that there were more than 17,000 and 25,000 U.S. and global Web sites, respectively, that each receive more than 30,000 unique visitors per month, as compared to only a few hundred channels typically available with standard digital cable or satellite television and broadcast or satellite radio. The complexities of online user activity and the breadth of digital content and advertising make providing digital marketing intelligence a technically challenging and highly data-intensive process.

Digital media continues to develop at a rapid pace and includes numerous formats such as textual content, streaming and downloadable video and music, instant messaging, VoIP telephony, online gaming and email.

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Digital advertising also includes multiple formats such as display, search, rich media and video. Detailed user activity such as viewing, clicking or downloading various components of a Web page across digital media or interacting with various advertising formats creates a substantial amount of data that must be captured on a continuous basis. The data must also be cleansed for quality, relevancy and privacy protection and be organized to enable companies to obtain relevant digital marketing intelligence. This capture of audience data can prove extremely challenging when it involves millions of Internet users with varying demographic characteristics accessing tens of thousands of Web sites across diverse geographies. In addition, the ongoing development of digital media programming languages and technologies contributes to the challenge of accurately measuring user activity. For example, online publishers and advertisers have recently started to use Asynchronous JavaScript and XML, or AJAX, a development technique that allows Web applications to quickly make incremental updates without having to refresh the entire Web page. Prior to AJAX, marketers relied heavily on page view statistics to plan and evaluate their online media spending programs. With AJAX, we believe marketers are beginning to question the definition of, and need for, page views, and are seeking alternative metrics for measuring the usage and effectiveness of online media. To maintain their relevance, audience and media measurement technologies must keep pace with the continued evolution and increasing complexity of digital media.

Need for Accuracy and Reliability. Relevant digital marketing intelligence requires access to accurate and reliable global data that measure online user activity. Existing data collection methodologies, including those that rely on third party sources, surveys or panels, face significant challenges and limitations. Survey or panel methodologies must measure a sufficiently large and representative sample size of Internet users to accurately capture data that is statistically projectable to the broader Internet population. In addition, the international composition of Internet audiences requires a geographically dispersed sample to accurately capture global digital activity. Digital marketing intelligence that depends on third-party sources to obtain Internet audience usage data has the potential to be biased, may be constrained by the data that the third party is capable of capturing, and may be limited in its application. For example, a solution that relies on data supplied by an Internet service provider, or ISP, may show a bias toward the demographic composition or other characteristics of that ISP s users. We believe that a meaningful digital media sourcing methodology must be based on data sourced from a large, representative global sample of online users that can be parsed, enhanced, mined and analyzed; must evolve rapidly and be flexible to adapt to changing technologies; and must be able to provide actionable digital marketing intelligence that can be used to improve business decision-making.

Need for Third-Party Objectivity. We believe that the availability of objective third-party data that measure digital audience size, behavior, demographic and attitudinal characteristics represents a key factor in the continued growth of digital content, advertising and commerce. This is similar to offline media markets, such as television and radio, whose development was significantly enhanced by the introduction of third-party audience measurement ratings that provided a basis for the pricing of advertising in those media. As the buying and selling of online advertising continues to grow, we believe that companies on both sides of the advertising transaction will increasingly seek third-party marketing intelligence to assess the value and effectiveness of digital media. In addition, as advertisers work with Web site publishers to target online advertising campaigns to reach a specific demographic or behavioral user profile, the need for objective audience and user information, unbiased by either party to the transaction, will become increasingly important.

Need for Competitive Information. In addition to the scope, complexity and rapid evolution of online digital media, the lack of data on competitors makes it difficult for companies to gain a comprehensive view of user behavior beyond their own digital businesses. While products and tools exist that enable companies to understand user activity on their own Web sites, these products are unable to provide a view of digital audience activity on other Web sites or offline. In order for publishers, marketers, merchants and service providers to benefit from accurate and comprehensive digital marketing intelligence they need to understand user activity on Web sites across the Internet and how online consumer behavior translates into offline actions.

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The comScore Digital Marketing Intelligence Platform

We provide a leading digital marketing intelligence platform that enables our customers to devise and implement more effective digital business strategies. Our platform is comprised of proprietary databases and a computational infrastructure that measures, analyzes and reports digital activity from our global panel of more than two million Internet users. We offer our customers deep insights into consumer behavior on their own online properties and those of their competitors, including objective, detailed information on users demographic characteristics, attitudes, lifestyles and multi-channel buying activity. We also provide industry-specific metrics to our customers.

We deliver our digital marketing intelligence through our comScore Media Metrix product family and through comScore Marketing Solutions. Media Metrix provides intelligence on digital media usage, including a measurement of the size, behavior and characteristics of the audiences for individual Web sites and advertising networks within the global home, work and university Internet user populations as well as insight into the effectiveness of online advertising. Our Marketing Solutions products combine the proprietary information gathered from our user panel with the vertical industry expertise of comScore analysts to deliver digital marketing intelligence customized for specific industries. Media Metrix and Marketing Solutions products are typically delivered electronically in the form of periodic reports, through customized analyses or are generally available online via a user interface on the comScore Web site.

Key attributes of our platform include:

Panel of global Internet users. Our ability to provide digital marketing intelligence is based on information continuously gathered from a broad cross-section of more than two million Internet users worldwide who have granted us explicit permission to confidentially measure their Internet usage patterns, online and certain offline buying behavior and other activities. Through our proprietary technology, we measure detailed Internet audience activity across the spectrum of digital content and marketing channels. Many comScore panelists also participate in online survey research that captures and integrates demographic, attitudinal, lifestyle and product preference information with Internet behavior data. The global nature of our Internet panel enables us to provide digital marketing intelligence for over 30 individual countries. Our global capability is valuable to companies based in international markets as well as to multi-national companies that want to better understand their global Internet audiences and the effectiveness of their global digital business initiatives.

Scalable technology infrastructure. We developed our databases and computational infrastructure to support the growth in online activity among our global Internet panel and the increasing complexity of digital content formats, advertising channels and communication applications. The design of our technology infrastructure is based on distributed processing and data capture environments that allow for the collection and organization of vast amounts of data on online activity, including usage of proprietary networks such as AOL, instant messaging and audio and video streaming. Our database infrastructure currently captures approximately 182 million Web pages and 4.5 billion URL records each week from our global Internet panel, resulting in over 28 terabytes of data collected by our platform each month. We believe that our efficient and scalable technology infrastructure allows us to operate and expand our data collection infrastructure on a cost-effective basis. In recognition of the scale of our data collection and warehousing technology, we have received multiple awards, including the 2003, 2004 and 2005 Winter Corporation Grand Prize for Database Size on a Windows NT Platform.

Benefits of our platform include:

Advanced digital marketing intelligence. We use our proprietary technology to compile vast amounts of data on Internet user activity and to organize the data into discrete, measurable elements that can be used to provide actionable insights to our customers. We believe that our digital marketing intelligence platform enables companies to gain a deeper understanding of their digital audiences, which allows them to better assess and improve their company and product-specific competitive position. Because our marketing intelligence is based on a large sample of global Internet users and can incorporate

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multi-channel transactional data, we are able to provide companies with an enhanced understanding of digital audience activity beyond their own Web sites and the ability to better assess the link between digital marketing and offline user activity. Digital content providers, marketers, advertising agencies, merchants and service providers can use the insights our platform provides to craft improved marketing campaigns and strategies and to measure the effectiveness and return on investment of their digital initiatives.

Objective third-party resource for digital marketing intelligence. We are an independent company that is not affiliated with the digital businesses we measure and analyze, allowing us to serve as an objective third-party provider of digital marketing intelligence. Because businesses use our data to plan and evaluate the purchase and sale of online advertising and to measure the effectiveness of digital marketing, it is important that we provide unbiased data, marketing intelligence, reports and analyses. We deploy advanced statistical methodologies in building and maintaining the comScore global Internet user panel and utilize proven data capture, and computational practices in collecting, statistically projecting, aggregating and analyzing information regarding online user activity. We believe that our approach ensures that the insights we provide are as objective as possible and allows us to deliver products and services that are of value to our customers in their key business decision-making. We believe that the media industry views us as a highly recognized and credible resource for digital marketing intelligence. For example, between March 1 and December 31, 2006, our information on digital activity was cited more than 16,500 times by third-party media outlets, an average of approximately 55 citations per day. Our data are regularly cited by well-known media outlets such as the Associated Press, Reuters, Bloomberg, CNBC, *The New York Times* and *The Wall Street Journal.* Moreover, many of the leading Wall Street investment banks also purchase and cite our data in their published research reports prepared by financial analysts that cover Internet businesses.

Vertical industry expertise. We have developed expertise across a variety of industries to provide digital marketing intelligence specifically tailored to the needs of our customers operating in specific industry sectors. We have dedicated personnel to address the automotive, consumer packaged goods, entertainment, financial services, media, pharmaceutical, retail, technology, telecommunications and travel sectors. We believe that companies across different industries have distinct information and marketing intelligence needs related to understanding their digital audiences and buyers, evaluating marketing initiatives and understanding company or product-specific competitive position. For example, a pharmaceutical company may want to understand how online research by consumers influences new prescriptions for a particular drug, while a financial services company may want to assess the effectiveness of its online advertising campaigns in signing up new consumers and how this compares to the efforts of its competitors. By working with companies in various industries over the course of multiple years, we have developed industry-specific applications of our data and our client service representatives have developed industry-specific knowledge and expertise that allow us to deliver relevant and meaningful marketing insight to our customers.

Ease of use and functionality. The comScore digital marketing intelligence platform is designed to be easy to use by our customers. Our Media Metrix products are available through the Internet using a standard browser. Media Metrix customers can also run customized reports and refine their analyses using an intuitive interface available on our Web site. Our Marketing Solutions products are available either through the Internet or by using standard software applications such as Microsoft Excel, Microsoft PowerPoint or SPSS analytical software. Our customers do not need to install additional hardware or complex software to access and use our products.

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Strategy

Our objective is to be the leading provider of global digital marketing intelligence products. We plan to pursue our objective through internal initiatives and, potentially, through acquisitions and other investments. The principal elements of our strategy are to:

Deepen relationships with current customers. We intend to work closely with our customers to enable them to continuously enhance the value they obtain from our digital marketing intelligence platform. Many of our customers are Fortune 1000 companies that deploy multiple marketing initiatives, and we believe many of our customers would benefit from more extensive use of our product offerings to gain additional insights into their key digital initiatives. We will work to develop and expand our customer relationships to increase our customers use of our digital marketing intelligence platform.

Grow our customer base. As the digital media, commerce, marketing and communications sectors continue to grow, we believe the demand for digital marketing intelligence products will increase. To meet this increase in market demand, we intend to invest in sales, marketing and account management initiatives in an effort to expand our customer base. We intend to offer both general and industry-specific digital marketing products that deliver value to a wide range of potential customers in current and new industry verticals.

Expand our digital marketing intelligence platform. We expect to continue to increase our product offerings through our digital marketing intelligence platform. As digital markets become more complex, we believe that companies will require new information and insights to measure, understand and evaluate their digital business initiatives. We intend to develop new applications that leverage our digital marketing intelligence platform to be able to provide the most timely and relevant information to our customers. For example, in 2003 we were one of the first companies to offer data, analysis and reports on the fast-growing Internet search market.

Address emerging digital media. The extension of digital media and communications to include new formats such as VoIP, IP television, content for mobile phones and next generation gaming consoles creates new opportunities to measure and analyze emerging digital media. We intend to extend our digital marketing platform to capture, measure and analyze user activity in these emerging digital media and communications formats.

Extend technology leadership. We believe that the scalability and functionality of our database and computational infrastructure provide us with a competitive advantage in the digital media intelligence market. Accordingly, we intend to continue to invest in research and development to extend our technology leadership. We intend to continue to enhance our technology platform to improve scalability, performance and cost effectiveness and to expand our product offerings.

Build brand awareness through media exposure. Our digital media, commerce and marketing information is frequently cited by media outlets. In addition, we proactively provide them with data and insights that we believe may be relevant to their news reports and articles. We believe that media coverage increases awareness and credibility of the comScore and Media Metrix brands and supplements our marketing efforts. We intend to continue to work with media outlets, including news distributors, newspapers, magazines, television networks, radio stations and online publishers, to increase their use of comScore data in content that discusses digital sector activity.

Grow internationally. While we are currently in the early stages of providing customers with international services, we believe that a significant opportunity exists to provide our product offerings to multi-national and international companies. Approximately half of the existing comScore Internet user panel resides outside of the United States. In July 2006, we launched World Metrix, a product that measures global digital media usage. World Metrix is based on a sample of online users from countries that comprise approximately 95% of the global Internet population. We plan to expand our sales and marketing and account management presence outside the U.S. as we provide a broader array of digital marketing intelligence products that are tailored to local country markets as well as the global marketplace.

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Our Product Offerings

We deliver our digital marketing intelligence through our comScore Media Metrix product family and through comScore Marketing Solutions.

comScore Media Metrix

Media Metrix provides its subscribers, consisting primarily of publishers, marketers, advertising agencies and advertising networks, with intelligence on digital media usage and a measurement of the size, behavior and characteristics of the audiences for Web sites and advertising networks among home, work and university Internet populations. Media Metrix also provides insights into the effectiveness of online advertising. Media Metrix data can be used to accurately identify and target key online audiences, evaluate the effectiveness of digital marketing and commerce initiatives, support the selling of online advertising by publishers, and to identify and exploit relative competitive standing. The vast majority of our Media Metrix subscribers access selected reports and analyses through the MyMetrix user interface on our Web site.

Our flagship product, Media Metrix 2.0, details the online activity and site visitation behavior of Internet users, including use of proprietary networks such as AOL, instant messaging, audio and video streaming, and other digital applications. Our customers subscribe to ongoing access to our digital marketing intelligence reports and analyses, including:

- comprehensive reports detailing online behavior for home, work and university audiences;
- demographic characteristics of visitors to Web sites and properties;
- buying power metrics that profile Web site audiences based on their online buying behavior;
- detailed measurement and reporting of online behavior for over 30 countries and over 100 U.S. local markets;
- measurement of key ethnic segments, including the online Hispanic population; and
- reach and frequency metrics for online advertising campaigns that show the percent of a target audience reached and the frequency of exposure to advertising messages.

A representative MyMetrix screenshot, detailing the most visited online properties in the United States for December 2006, is shown on the following page.

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In addition to our core offering, customers can subscribe to the following additional products in the Media Metrix product family:

Plan Metrix. Plan Metrix is a product that combines the continuously and passively observed Internet behavior provided by Media Metrix with comprehensive attitude, lifestyle and product usage data collected through online surveys of our U.S. Internet user panel. Plan Metrix provides advertising agencies, advertisers and publishers with multiple views of Web site audiences including their online behavior, demographics, lifestyles, attitudes, technology product ownership, product purchases and offline media usage. These data are used in the design and evaluation of online marketing campaigns. For example, an online auto retailer could use Plan Metrix to help understand which Web sites a prospective automobile purchaser is most likely to visit prior to making a purchase decision.

World Metrix. We provide insights into worldwide Internet activity through our World Metrix product, which delivers aggregate information about the behavior of online users on a global basis, for approximately 30 individual countries and for regional aggregations such as Latin America, Europe and Asia Pacific. For example, a content publisher can understand its market share of the global Internet audience using our World Metrix product.

Video Metrix. Video Metrix provides insights into the viewing of streaming video by U.S. Internet users. The product measures a wide range of video players and formats, including Windows Media, Flash, RealMedia and QuickTime. Video Metrix offers site-level measurement and audience ratings by demographics and time-of-day to assist agencies, advertisers and publishers in designing and implementing media plans that include streaming video. For example, an advertiser that is seeking to maximize the exposure of its streaming video ads to its target audience could use Video Metrix to help understand on which sites and at what times of the day its target audience is viewing the most streaming video.

Ad Metrix. Available through the Media Metrix client interface, Ad Metrix provides advertisers, agencies and publishers with a variety of online advertising metrics relating to impressions, or advertisements on a Web site that reach a target audience. Ad Metrix helps customers determine the impressions delivered by advertising campaigns across Web sites and online properties, including how many visitors are reached with advertisements and how often. In addition, Ad Metrix allows customers to determine the demographic profile of the advertising audience at a particular site, as well as how the volume of impressions changes over time on that site. The Ad Metrix data are consistent with offline media planning metrics such as GRPs, or gross rating points, which measure the percent of a target audience that is reached with an advertisement weighted by the number of exposures. For example, an advertiser might use Ad Metrix to plan the online portion of an advertising campaign for a sports product on sites that have previously successfully delivered advertising impressions to a target demographic audience. A publisher might use Ad Metrix data to measure its share of advertising impressions relative to competitive publishers. Ad Metrix was launched in early 2007 in beta format and we plan to commercially launch this product in the second quarter of 2007.

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Some examples of Media Metrix digital marketing intelligence measurements and their customer uses are described in the following table.

Digital Marketing Intelligence Measurement	Examples of Customer Uses
Site Traffic & Usage Intensity	rank Web sites based on online usage metrics such as unique visitors, page views or minutes of use drill-down to standard or customer-defined site subsets such as channels or sub-channels (such as Yahoo! Finance and Yahoo! Sports) analyze statistics over time such as trends in site visitors within demographic segments assess which Web site audiences are growing or declining, which sites are most attractive to particular demographic segments or which sites or digital applications have the highest level of usage identify the source of traffic to a particular Web site or channel within a site
Quantitative Consumer Information	profile site users based on life-stage or offline behavior such as panelist-reported TV usage, car ownership, health conditions or offline purchases efficiently identify and target a particular user segment (e.g., people who say they are likely to buy a car in the next six months) quantify the audience overlap between different consumer segments or Web sites to identify the number of unique visitors reached
Online Buying Power	quantify the propensity of a particular Web site s audience to purchase certain categories of products (e.g., consumer electronics) online
Competitive Intelligence	compare the standings of Web sites within particular content categories, such as finance or health information quantify audience size relative to competitors, including share of usage within a category and usage trends across competitors track major competitors, quantify their growth, and identify initiatives to promote growth and market share
Reach and Frequency	identify and quantify the size of audiences reached by individual Web sites and determine how often they reach those audiences assist with the planning of online advertising campaigns that need to achieve specific reach or frequency objectives against a targeted audience across multiple Web sites design the most cost-effective media plans that can achieve campaign objectives for reach and frequency

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comScore Marketing Solutions

comScore Marketing Solutions products use our global database, computational infrastructure and our staff of experienced analytical personnel to help customers design more effective marketing strategies that increase sales, reduce costs, deepen customer relationships and ultimately enhance a customer s competitive position. We offer solutions tailored for specific industry verticals, including the automotive, consumer packaged goods, entertainment, financial services, media, pharmaceutical, retail, technology, telecommunications and travel sectors. Many of our Marketing Solutions products are delivered to subscribers on a recurring schedule such as monthly or quarterly. In some cases, we provide customized reports and analyses that combine our expertise with other proprietary information to address a specific customer need.

The core information products offered by comScore Marketing Solutions include:

Market Share Reports. These reports track a company s share of market as measured by industry-specific performance metrics. The metrics of choice vary by industry vertical, including as examples: share of online credit card spending for credit card issuers; share of online travel spending for travel companies; or share of subscribers for ISPs. In each case, market share reports provide an ongoing measurement of competitive performance and insight into the factors driving changes in market share.

Competitive Benchmark Reports. These reports allow customers to compare themselves to competitors using various industry-specific metrics. For example, retailers may look at metrics such as the rate of conversion of site visitors to buyers, average order size or rate of repeat purchases among existing customers. Banks may focus on the percentage of bank customers using online bill payment services, or compare the effectiveness of customer acquisition programs as reflected by the percentage of leads they acquire that ultimately sign up for an online account. In each case, a customer may define and obtain best-of-category metrics and use them as a benchmark to monitor its business performance over time.

Loyalty and Retention Analysis. These analyses provide an understanding of the extent to which consumers are also engaged with competitors, and identifies loyalty drivers to assist customers in capturing a higher share of the consumer s wallet. For example, a travel company might quantify the potential business lost when consumers visit its site, do not complete a purchase but then visit a competing site to book a travel reservation. Retention or churn analyses quantify consumer losses to competitors and the key drivers of such losses. For example, a narrowband Internet service provider may track the rate of attrition among its customer base, identify which competitors are capturing those lost customers, and analyze the characteristics of the lost customers in order to gain insight into ways to improve retention.

Customer Satisfaction Reports. These reports are based on panelist responses to survey questionnaires that ascertain the degree of satisfaction with various products or services offered to consumers. This information is often integrated with the online usage information that we collect from our panelists in order to identify which digital media usage activities affect customer satisfaction. For instance, a sports portal may use these reports to determine which features, such as participating in fantasy sports leagues or viewing streaming video clips, affect customer satisfaction and loyalty the most.

qSearch. This product is a monthly scorecard of the search market that provides a comparison of search activity across portals and major search engines. It helps identify the reach of a search engine, the loyalty of its user base, the frequency of search queries, and the effectiveness of sponsored links displayed on search result pages in driving referrals to advertiser sites. qSearch is used by major search engines and advertising agencies in planning search campaigns.

Campaign Metrix. This product provides detailed information about specific online advertising campaigns. These reports, available through a Web-based interface, describe for each advertising image, or creative within an advertising campaign, the size and demographic composition of the audience exposed to that particular advertisement, the average number of impressions delivered and other details regarding ad formats and ad sizes used in the campaign. An advertiser, agency or publisher could use Campaign Metrix to gain insight into the effectiveness of an online advertising campaign by examining the number of unique users exposed to the campaign, the number of times on average that a unique user was exposed to the campaign and

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whether the campaign reached the targeted audience demographic. This product was launched in February 2007 in beta format and we plan to commercially launch this product in the second quarter of 2007.

Internet Advertising Effectiveness Studies. These studies provide an understanding of the effectiveness of particular advertising campaigns by measuring the online and offline behavior of a target group of comScore panelists, following their exposure to a particular advertisement, and comparing their behavior to that of a control group of comScore panelists who were not exposed to such advertisements. This type of a study allows a marketer to understand the impact of their advertising campaign and to estimate the return on their investment in online marketing.

Survey-Based Products. These products leverage our ability to administer surveys to our panel members to obtain valuable information that can be seamlessly integrated with online behavioral data to provide our clients with additional insights into the drivers of consumer behavior.

Customers

As of March 31, 2007, we had 743 customers, including over 100 Fortune 1000 customers. Our customers include:

- fifteen of the top twenty online properties, based on total unique visitors, as ranked by our Media Metrix database for the month of December 2006, including Microsoft, Yahoo!, AOL and Google;
- ten of the top twenty U.S. Internet service providers, based on the number of subscribers as of the third quarter of 2006, as ranked by ISP Planet;
- the top ten investment banks, based on 2006 revenues, as ranked by Dealogic;
- 97 advertising and media buying agencies;
- five of the top six consumer banks, based on consolidated assets as of December 31, 2006, as ranked by the Federal Reserve System, National Information Center;
- seven of the top ten pharmaceutical companies, based on 2005 worldwide sales, as ranked by IMS Health; and
- seven of the top eight credit card issuers, based on total credit cards outstanding in 2006, as ranked by the 2006 Nilson Report.

One of our customers, Microsoft Corporation, accounted for 5%, 14%, 12% and 12% of our revenues in the year ended December 31, 2004, 2005 and 2006 and the three months ended March 31, 2007, respectively.

The following examples are provided as an illustration of the development and growth of our relationships with our customers:

Microsoft is a leading provider of software, services and solutions. Since 2001, Microsoft s Internet division, MSN, has used our global panel data to better understand the needs of consumers, to help guide product planning strategies and to measure the impact of online marketing efforts, and has increased its use of our products in each subsequent year. Since 2004, MSN has purchased detailed Internet clickstream data patterns to study how consumers use MSN and competitive services, in order to better meet consumer needs. Since June 2005, MSN has used our qSearch product to measure and benchmark the behavior of consumers and competitors in the Internet search market. Since 2005, we have also provided MSN with advertising studies that it has used to measure the impact of MSN s online marketing campaigns and demonstrate to clients the effectiveness of online advertising. In addition, since 1999, Microsoft has been a customer of SurveySite, a company that we acquired on December 31, 2004. comScore SurveySite provides Microsoft with insights about their customers, partners and employees by conducting online qualitative research and quantitative surveys, including ongoing customer satisfaction tracking programs. comScore SurveySite has been a Premier Vendor for Online Research to Microsoft since 2002. comScore SurveySite was also the winner of the 2005 Microsoft Vendor Program Excellence Award in Technology in recognition of its innovative SiteRecruit system. In 2006, comScore SurveySite was also named a Relationship Marketing Specialty Vendor, a designation shared by only five market research vendors worldwide. comScore SurveySite has worked across all of Microsoft s principal business groups including Platform Products and Services, Business Products and Services and Entertainment and Devices.

Verizon Communications is a leader in delivering broadband and other wireline and wireless communication innovations to business, government and wholesale and retail customers. Since 2001, Verizon Communications has used comScore Marketing Solutions products to better understand the competitive landscape in the Internet access industry and trends in broadband offerings. Starting with the purchase of an ISP market share analysis for two specific markets, Verizon Communications now uses our data and analyses in over 40 markets to not only understand its competitive position in the industry, but also to determine the efficacy of its broadband product line and to help guide marketing strategies. Verizon Communications also uses other comScore Marketing Solutions products to obtain answers to a variety of other business issues.

Starcom USA is an independent operating unit of Starcom MediaVest Group, a global advertising and marketing agency. Starcom has been a customer of comScore s Marketing Solutions products since 2004, when it purchased an analysis to quantify the impact of a Fortune 500 client s online advertising on its share of consumer eCommerce spending during the 2003 holiday shopping season. In 2005, Starcom expanded the relationship to include comScore Marketing Solutions online survey capabilities. Since 2004, Starcom s purchases of our products have expanded from purchasing surveys and holiday season eCommerce tracking to purchases covering almost the entire year. Starcom uses our digital market intelligence to analyze the impact of online advertising on its clients share of consumer eCommerce spending at a total Internet and product category level. Starcom also uses our marketing solutions brand accountability analyses that we generate from survey results from our global consumer Internet panel.

Yahoo! is a leading global Internet portal. Yahoo! became a customer when we acquired certain Media Metrix assets in 2002. Since then, Yahoo! has purchased additional Media Metrix products and in 2004 chose comScore as Yahoo! s source of record for Internet audience measurement and search. Yahoo! has exclusively used Media Metrix for digital marketing intelligence in the U.S. since 2006. In 2002, our relationship with Yahoo! expanded with the launch of our qSearch product that tracks consumers use of various search engines. qSearch information is used by Yahoo! in numerous aspects of managing its search business, including product development, market share tracking, competitive analysis, ad effectiveness and executive reporting. Yahoo! also commissioned us to conduct several analyses that measured the degree to which offline sales and latent online sales (sales made days or weeks after the initial click-through) were impacted by search advertising. In late 2005 and throughout 2006, Yahoo! integrated our advertising effectiveness testing products into its suite of advertiser products, thereby enabling its advertisers to analyze campaign effectiveness by measuring a variety of different metrics including offline sales, surveyed branding and awareness, online site usage and trademark search activity. In 2006, we completed two significant studies for Yahoo! entitled Close the Loop a study on the link between search and image advertising, and Brand Advocates: The Impact of Search and Social Media on Branding. We became a preferred provider of services to Yahoo! in 2006. In 2007, our relationship with Yahoo! grew with the addition of international and worldwide data and ongoing adoption of certain of our new syndicated and custom comScore digital marketing intelligence products.

Selling and Marketing

We sell the majority of our products through a direct sales force. Sales of the comScore Media Metrix product suite to new clients are managed by sales representatives assigned specifically to new business development. A separate group of account managers within our sales organization is assigned to manage, renew and increase sales to existing Media Metrix customers. The comScore Marketing Solutions sales organization is organized vertically by industry with account executives dedicated to selling into the automotive, consumer packaged goods, entertainment, financial services, media, pharmaceutical, retail,

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technology, telecommunications and travel sectors and other industries. Marketing Solutions account executives are tasked with both identifying and generating new business in specific verticals as well as servicing existing customers. Our sales and account representatives receive a base salary and are eligible for bonuses or commissions based on performance.

Our marketing communications staff is primarily focused on leveraging the use of comScore data and insights by the media and maximizing the number of times that comScore is cited as a source of information. We believe that the use of our data by general and industry-specific media outlets increases recognition of the comScore brand name and serves to help validate the value of the analyses and products we provide. In order to accomplish this goal, we seek to maintain relationships with key news distributors, publications, TV networks, reporters and other media outlets. We believe that the media views us as a highly recognized and credible resource for digital marketing intelligence. For example, between March 1 and December 31, 2006, comScore data were cited more than 16,500 times by third-party media outlets, an average of over 55 citations per day. Moreover, we are regularly cited by well-known news distributors, publications and TV networks such as the Associated Press, Reuters, Bloomberg, CNBC, *The New York Times* and *The Wall Street Journal.* We also target various industry conferences and tradeshows as part of our marketing efforts. These events are typically focused on a particular industry, allowing us to demonstrate to industry participants the value of our products to businesses in that industry.

Panel and Methodology

The foundation of our digital marketing intelligence platform is data collected from our comScore panel, which includes more than two million persons worldwide whose online behavior we have explicit permission to measure on a continuous, passive basis. We believe that our panel is one of the largest global panels of its kind, delivering a multi-faceted view of digital media usage and transactional activity as well as selected offline activity. By applying advanced statistical methodologies to our panel data, we project the behavior of the total online population.

We recruit our panel through a variety of online recruitment programs that have been tested and refined since our inception to ensure a diverse sample that sufficiently represents the broader global Internet population. In addition, in the United States we enlist a sub-sample of panelists through various offline recruiting methods. Participants in the comScore research panel receive a package of benefits that is designed to appeal to a broad variety of user categories. Examples of such benefits include, as of December 2006, free security applications such as server-based virus protection, encrypted file protection, encrypted network disk storage locations for user backups; free general purpose applications such as screensavers and games; sweepstakes; cash payments; and points that may be redeemed for prizes. Participants data and privacy are protected by defined privacy policies that safeguard personally-identifiable information. This combination of recruiting methods allows us to maintain a panel large enough to provide statistically representative samples in most demographic segments.

We continuously determine the size, demographics and other characteristics of the online population using enumeration surveys of tens of thousands of persons annually, whereby respondents are asked a variety of questions about their Internet use, as well as demographic and other descriptive questions about themselves and their households. The sample of participants in each enumeration survey is selected using a random recruiting methodology. The result is an up-to-date picture of the population to which the comScore sample is then projected. We use the results from the enumeration surveys to weight and statistically project the panel data to ensure that the projected data reflect the characteristics of the Internet population.

Privacy

We believe that a key factor differentiating our digital marketing intelligence is our ability to track and analyze online usage behavior using the data collected from our panel. Since the founding of our company, we have endeavored to undertake such data collection and analysis responsibly and only with consumer permission. Participation in our research panel is voluntary. Participants must consent to our privacy and data security practices before our software collects information on the user s online activity. In addition, we provide panelists with multiple opportunities and methods to remove themselves from our panel. We limit the type of information that we collect by identifying and filtering certain personal information from the data collected. The collected data is secured using multiple layers of physical and digital security mechanisms. Moreover, we maintain a strict policy of not sharing panelists personally identifiable information with our customers. These actions and policies are consistent with the AICPA/CICA WebTrust criteria for online privacy.

Technology and Infrastructure

We have developed a proprietary system for the measurement of the activity of our global online panel. This system is continuously refined and developed to address the changing digital media landscape and to meet new customer business needs. The system is comprised of hundreds of servers that operate using software built on Microsoft and other technologies. Our technology infrastructure is operated in two third-party Tier-1 co-location facilities (one in Virginia and the other in Illinois). Our systems have multiple redundancies and are structured to ensure the continuation of business operations in the event of network failure or if one of our data centers has been rendered inoperable. As of December 31, 2006, our technology team (excluding employees devoted to research and development) was comprised of over 105 full-time employees (or full-time equivalents) working in four different geographic locations, who design, develop, maintain and operate our entire technology infrastructure. In addition, we have established a relationship with a third party firm for software development in an economically beneficial locale as a means to augment our technology efforts for discrete projects.

Our development efforts have spanned all aspects of our business. We have developed a data capture system that operates across our panelists computers in almost 200 countries and is used for the real-time capture of consumer Internet behavior. We have built a large scale, efficient and proprietary system for processing massive amounts of data. Typically our systems handle and process data in excess of 10 billion input records per month. Despite the scale of processing required, these data are generally available on a daily basis for our business use. We have also developed a highly efficient and scalable system for the extraction and tabulation of all online activities of our panelists. Likewise, we have created a highly scalable data warehousing environment that allows ready access and analysis of the data we collect. This system, based on Sybase IQ, was awarded the 2003, 2004 and 2005 Grand Prize for the largest Microsoft-based decision support warehouse by the Winter Corporation. In December 2006, we were recognized as a 2007 Technology Pioneer by the World Economic Forum. We believe our scalable and highly cost-effective systems and processing methods provide us with a significant competitive advantage.

Our customers access our digital marketing intelligence product offerings through a variety of methods including MyMetrix, our proprietary, Web-based analysis and reporting system, which in the month of December 2006 was used by 4,020 users to produce more than 170,000 reports.

Research and Development

Our research and development efforts focus on the enhancement of our existing products and the development of new products to meet our customers digital marketing intelligence needs across a broad range of industries and applications. Because of the rapidly growing and evolving use of the Internet and other digital mediums for commerce, content, advertising and communications, these efforts are critical to satisfying our customers demand for relevant digital marketing intelligence. As of March 31, 2007, we had approximately 85 full-time employees (or full-time equivalents) working on research and development activities (excluding employees on our technology team cited under Technology and Infrastructure above). In addition, we involve management and operations personnel in our research and development efforts. In 2006, 2005 and 2004, we spent $9.0 million, $7.4 million and $5.5 million, respectively, on research and development. During the three months ended March 31, 2007, we spent $2.6 million on research and development.

Intellectual Property

We rely on a combination of patent, trademark, copyright and trade secret laws in the United States and other jurisdictions together with confidentiality procedures and contractual provisions to protect our proprietary technology and our brand. We seek patent protection on inventions that we consider important to the development of our business. We control access to our proprietary technology and enter into confidentiality and invention assignment agreements with our employees and consultants and confidentiality agreements with other third parties.

Our success depends in part on our ability to develop patentable products and obtain, maintain and enforce patent and trade secret protection for our products, including successfully defending these patents against any third-party challenges, both in the United States and in other countries. We may be able to protect our technologies from unauthorized use by third parties to the extent that we own or have licensed valid and enforceable patents or trade secrets that cover them. However, the degree of future protection of our proprietary rights is uncertain because legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep our competitive advantage.

Currently, we own U.S. patent 7,181,412, which was filed March 22, 2000 and covers, among other things, techniques for collecting consumer data. Under current U.S. law, the statutory term for a patent is 20 years from its earliest effective filing date. Accordingly, U.S. patent 7,181,412 is expected to expire on March 22, 2020. However, various circumstances, such as the provisions under U.S. patent law for patent term adjustment and patent term extension, may extend the duration of this patent. Similarly, various circumstances may shorten the duration of this patent, such as a change in U.S. law or a need or decision on our part to terminally disclaim a portion of the statutory term of this patent.

We also currently have twelve U.S. and foreign patent applications pending, and we intend to file, or request that our licensors file, additional patent applications for patents covering our products. However, patents may not be issued for any pending or future pending patent applications owned by or licensed to us, and claims allowed under any issued patent or future issued patent owned or licensed by us may not be valid or sufficiently broad to protect our technologies. Any issued patents owned by or licensed to us now or in the future may be challenged, invalidated, held unenforceable or circumvented, and the rights under such patents may not provide us with the expected benefits. In addition, competitors may design around our technology or develop competing technologies. Intellectual property rights may also be unavailable or limited in some foreign countries, which could make it easier for competitors to capture or increase their market share with respect to related technologies. Although we are not currently involved in any legal proceedings related to intellectual property, we could incur substantial costs to defend ourselves in suits brought against us or in suits in which we may assert our patent rights against others. An unfavorable outcome in any such litigation could have a material adverse effect on our business and results of operations.

In addition to patent and trade secret protection, we also rely on several trademarks and service marks to protect our intellectual property assets. We are the owner of numerous trademarks and service marks and have applied for registration of our trademarks and service marks in the United States and in certain other countries to establish and protect our brand names as part of our intellectual property strategy. Some of our registered marks include comScore, Media Metrix and MyMetrix.

Our intellectual property policy is to protect our products, technology and processes by asserting our intellectual property rights where we believe it is appropriate and prudent. Any pending or future pending patent applications owned by or licensed to us (in the United States or abroad) may not be allowed or may in the future be challenged, invalidated, held unenforceable or circumvented, and the rights under such patents may not provide us with competitive advantages. Any significant impairment of our intellectual property rights could harm our business or our ability to compete. 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.

There is always the risk that third parties may claim that we are infringing upon their intellectual property rights and, if successful in proving such claims, we could be prevented from selling our products.

For additional, important information related to our intellectual property, please review the information set forth in Risk Factors Risks Related to Our Business, Our Technologies and Our Industry.

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Competition

The market for digital marketing intelligence is highly competitive and evolving rapidly. We compete primarily with providers of digital marketing intelligence and related analytical products and services. We also compete with providers of marketing services and solutions, with survey providers, as well as with internal solutions developed by customers and potential customers. Our principal competitors include:

- large and small companies that provide data and analysis of consumers online behavior, including Compete Inc., Hitwise Pty. Ltd and NetRatings, Inc.;
- online advertising companies that provide measurement of online ad effectiveness, including aQuantive, Inc., DoubleClick Inc., ValueClick Inc., and WPP Group plc;
- companies that provide audience ratings for TV, radio and other media that have extended or may extend their current services, particularly in certain international markets, to the measurement of digital media, including Arbitron Inc., Nielsen Media Research, Inc. and Taylor Nelson Sofres plc;
- analytical services companies that provide customers with detailed information of behavior on their own Web sites, including Omniture, Inc., WebSideStory, Inc. and WebTrends Corporation;
- full-service market research firms and survey providers that may measure online behavior and attitudes, including Harris Interactive Inc., Ipsos Group, Taylor Nelson Sofres plc and The Nielsen Company; and
- specialty information providers for certain industries that we serve, including IMS Health Incorporated (healthcare) and Telephia, Inc. (telecommunications).

Some of our current competitors have longer operating histories, relationships with more customers and substantially greater resources than we do. As a result, these competitors may be able to devote more resources to marketing and promotional campaigns, panel retention and development techniques or technology and systems development than we can. In addition, some of our competitors may be able to adopt more aggressive pricing policies. Furthermore, large software companies, Internet portals and database management companies may enter the market or enhance their current offerings, either by developing competing services or by acquiring our competitors, and could leverage their significant resources and pre-existing relationships with our current and potential customers.

We believe the principal competitive factors in our markets include the following:

- the ability to provide actual and perceived high-quality, accurate and reliable data regarding Internet and other digital media audience behavior and activity in a timely manner, including the ability to maintain a large and statistically representative sample panel;
- the ability to adapt product offerings to emerging digital media technologies and standards;
- the breadth and depth of our products and their flexibility and ease of use;
- the availability of data across various industry verticals and geographic areas and our expertise across these verticals and in these geographic areas;

- the ability to offer survey-based information combined with digital media usage, eCommerce data and other online information collected from panelists;
- the ability to offer high-quality analytical services based on Internet and other digital media audience measurement information;
- the ability to offer products that meet the changing needs of customers and provide high-quality service; and
- the prices that are charged for products based on the perceived value delivered.

We believe that we compete favorably with our competitors on the basis of these factors. However, if we are unable to compete successfully against our current and future competitors, we may not be able to acquire and retain customers, and we may consequently experience a decline in revenues, reduced operating margins, loss of market share and diminished value from our products.

Government Regulation

Although we do not believe that significant existing laws or government regulations adversely impact us, our business could be affected by different interpretations or applications of existing laws or regulations, future laws or regulations, or actions by domestic or foreign regulatory agencies. For example, privacy concerns could lead to legislative, judicial and regulatory limitations on our ability to collect, maintain and use information about Internet users in the United States and abroad. Various state legislatures, including those of Utah and California, have enacted legislation designed to protect Internet users privacy, for example by prohibiting spyware. In recent years, similar legislation has been proposed in other states and at the federal level and has been enacted in foreign countries, most notably by the European Union, which adopted a privacy directive regulating the collection of personally identifiable information online. These laws and regulations, if drafted or interpreted broadly, could be deemed to apply to the technology we use, and could restrict our information collection methods or decrease the amount and utility of the information that we would be permitted to collect. In addition, our ability to conduct business in certain foreign jurisdictions, including China, is restricted by the laws, regulations and agency actions of those jurisdictions. The costs of compliance with, and the other burdens imposed by, these and other laws or regulatory actions may prevent us from selling our products or increase the costs associated with selling our products, and may affect our ability to invest in or jointly develop products in the United States and in foreign jurisdictions. In addition, failure to comply with these and other laws and regulations may result in, among other things, administrative enforcement actions and fines, class action lawsuits and civil and criminal liability. State attorneys general, governmental and non-governmental entities and private persons may bring legal actions asserting that our methods of collecting, using and distributing Web site visitor information are illegal or improper, which could require us to spend significant time and resources defending these claims. For example, some companies that collect, use and distribute Web site visitor information have been the subject of governmental investigations and class-action lawsuits. Any such regulatory or civil action that is brought against us, even if unsuccessful, may distract our management s attention, divert our resources, negatively affect our public image or reputation among our panelists and customers and harm our business. The impact of any of these current or future laws or regulations could make it more difficult or expensive to attract or maintain panelists, particularly in affected jurisdictions, and could adversely affect our business and results of operations.

Additionally, laws and regulations that apply to communications and commerce over the Internet are becoming more prevalent. In particular, the growth and development of the market for eCommerce has prompted calls for more stringent tax, consumer protection and privacy laws in the United States and abroad that may impose additional burdens on companies conducting business online. The adoption, modification or interpretation of laws or regulations relating to the Internet or our customers digital operations could negatively affect the businesses of our customers and reduce their demand for our products. For additional, important information related to government regulation of our business, please review the information set forth in Risk Factors Risks Related to Our Business and Our Technologies.

Employees

As of December 31, 2006, we had 377 employees. None of our employees is represented by a labor union. We have experienced no work stoppages and believe that our employee relations are good.

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Legal

Generally, we are involved in various legal proceedings arising from the normal course of business activities. Currently, we do not believe that resolution of these matters will have a material adverse impact on our consolidated results of operations, cash flows or our financial position. However, depending on the amount and timing, an unfavorable resolution of a matter could materially affect our future results of operations, cash flows or financial position in a particular period.

Facilities

Our corporate headquarters and executive offices are located in Reston, Virginia, where we occupy approximately 34,000 square feet of office space under a lease that expires in June 2008. We also lease space in various locations throughout the United States and in Toronto and London for sales and other personnel. If we require additional space, we believe that we would be able to obtain such space on commercially reasonable terms.

MANAGEMENT

Executive Officers and Directors

The following table sets forth certain information concerning our current executive officers and directors:

Name	Age	Position(s)
Executive Officers		
Magid M. Abraham, Ph.D.	48	President, Chief Executive Officer and Director
Gian M. Fulgoni	59	Executive Chairman of the Board of Directors
John M. Green	55	Chief Financial Officer
Gregory T. Dale	37	Chief Technology Officer
Christiana L. Lin	37	General Counsel and Chief Privacy Officer
Non-Employee Directors:		
Thomas D. Berman(1)(2)	49	Director
Bruce Golden(3)	48	Director
William J. Henderson(2)(3)	59	Director
Ronald J. Korn(1)(3)	67	Director
Frederick R. Wilson(1)(2)	45	Director

(1) Member of the audit committee.

(2) Member of the compensation committee.

(3) Member of the nominating and governance committee.

Magid M. Abraham, Ph.D., one of our co-founders, has served as President, Chief Executive Officer and Director since September 1999. In 1995, Dr. Abraham founded Paragren Technologies, Inc., which specialized in delivering large scale Customer Relationship Marketing systems for strategic and target marketing, and served as its Chief Executive Officer from 1995 to 1999. Prior to founding Paragren, Dr. Abraham was employed by Information Resources, Inc. from 1985 until 1995, where he was President and Chief Operating Officer from 1993 to 1994 and later Vice Chairman of the Board of Directors from 1994 until 1995. Since May 2006, Dr. Abraham has also been a member of the board of directors of ES3, LLC, a storage and logistics services company. Dr. Abraham received the Paul Green Award in 1996 and the William F. O Dell Award in 2000 from the American Marketing Association for a 1995 article that he co-authored in the Journal of Marketing Research. He received a Ph.D. in Operations Research and an M.B.A. from MIT. He also holds an Engineering degree from the École Polytechnique in France.

Gian M. Fulgoni, one of our co-founders, has served as Executive Chairman of the Board of Directors since September 1999. Prior to co-founding comScore, Mr. Fulgoni was employed by Information Resources, Inc., where he served as President from 1981 to 1989, Chief Executive Officer from 1986 to 1998 and Chairman of the Board of Directors from 1991 until 1995. Mr. Fulgoni has served on the board of directors of PetMed Express, Inc. since 2002 and previously served from August 1999 through November 2000. Mr. Fulgoni also serves on the board of directors of INXPO, LLC, an Illinois-based provider of virtual events, since July 2005. He also served on the board of directors of Platinum Technology, Inc. from 1990 to 1999, U.S. Robotics, Inc. from 1991 to 1994, and Yesmail.com, Inc. from 1999 to 2000. Mr. Fulgoni has twice been named an Illinois Entrepreneur of the Year. In 1992, he received the Wall Street Transcript Award for outstanding contributions as Chief Executive Officer of Information Resources, Inc. in enhancing the overall value of that company to the benefit of its shareholders. Educated in the United Kingdom, Mr. Fulgoni holds an M.A. in Marketing from the University of Lancaster and a B.Sc. in Physics from the University of Manchester.

John M. Green has served as Chief Financial Officer since May 2006. Prior to joining comScore, Mr. Green served as the Chief Financial Officer and U.S. Services Business Leader for BioReliance, a subsidiary of Invitrogen Corporation, from 2004 to March 2006. Prior to joining BioReliance, Mr. Green served as the General Manager, Business Integrations at Invitrogen from September 2003 to April 2004. From March 2001 through August 2003, Mr. Green served as the Chief Financial Officer for InforMax, and as its Chief Operating Officer from October 2001 until the sale of InforMax and integration into Invitrogen in August 2003. Prior to 2001, Mr. Green held several financial and operating management roles, including serving as Executive Vice President of Operations at HMSHost Corporation, Senior Vice President of Finance and Corporate Controller at Marriott International Incorporated and Director of Business Planning and Director of Finance, Central Europe, at PepsiCo, Inc. Mr. Green received an M.Sc. in Economics from The London School of Economics and a B.A. in Political Science/International Relations from Tufts University.

Gregory T. Dale has served as Chief Technology Officer since October 2000. Prior to that, he served as Vice President, Product Management starting in September 1999. Prior to joining us, he served as Vice President of Client Service at Paragren Technologies, Inc., a company that specialized in enterprise relationship marketing. He holds a B.S. in Industrial Management from Purdue University.

Christiana L. Lin has served as General Counsel and Chief Privacy Officer since January 2006. Prior to that, she served as our Corporate Counsel and Chief Privacy Officer starting in March 2003. Prior to that, she served as our Deputy General Counsel starting in February 2001. Ms. Lin holds a J.D. from the Georgetown University Law Center and a B.A. in Political Science from Yale University.

Thomas D. Berman has served as a director since August 2001. Mr. Berman is a partner with Adams Street Partners, where he has led investments in information technology and business services companies since 1990. He served on the board of directors of PathScale, Inc. from May 2004 to April 2006 and has served on the board of directors of Adams Harris, Inc. since March 2006. Mr. Berman holds an S.B. in Electrical Engineering from MIT and an S.M. from the Sloan School of Management at MIT.

Bruce Golden has served as a director since June 2002. He is a partner at Accel Partners, which he joined in 1997. Mr. Golden has led a number of investments in enterprise software and Internet-related companies while at Accel and currently serves as a member of the boards of directors at several private companies. He holds an M.B.A. from Stanford University and a B.A. from Columbia University.

William J. Henderson has served as a director since August 2001. Mr. Henderson was the 71st Postmaster General of the United States. He served in that position from May 1998 until his retirement in May 2001. Mr. Henderson also served as the Chief Operations Officer of Netflix, Inc. from January 2006 until February 2007. Mr. Henderson also currently serves on the board of directors of Acxiom Corporation, where he has been a director since June 2001. Mr. Henderson holds a B.S. from the University of North Carolina at Chapel Hill and served in the U.S. Army.

Ronald J. Korn has served as a director since November 2005. Since 1991, he has served as the President of Ronald Korn Consulting, which provides business and marketing services. Mr. Korn served as a director, chairman of the audit committee, and member of the loan committee of Equinox Financial Corporation from 1999 until its acquisition in October 2005. Since 2002, he has served as a director, chairman of the audit committee and a member of the compensation and nominating and governance committees of PetMed Express, Inc. and since July 2003, he has served as a director, chairman of the audit committee and a member of the compensation committee of Ocwen Financial Corporation. Prior to that, Mr. Korn was a partner and employee of KPMG, LLP, from 1961 to 1991, where he was the managing partner of KPMG s Miami office from 1985 until 1991. Mr. Korn holds a B.S. from the University of Pennsylvania, Wharton School and a J.D. from New York University Law School.

Frederick R. Wilson has served as a director since August 1999. He has served as managing partner of Union Square Ventures since August 2003. He is also a managing partner of Flatiron Partners and has held that position since August 1996. He holds an M.B.A. from the Wharton School of Business at the University of Pennsylvania and an S.B.

in Mechanical Engineering from MIT.

Board Composition

Upon completion of this offering, our directors will be divided into three classes serving staggered three-year terms. Class I, Class II and Class III directors will serve until our annual meetings of stockholders in

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2008, 2009 and 2010, respectively. Upon expiration of the term of class of directors, directors in that class will be eligible to be elected for a new three-year term at the annual meeting of stockholders in the year in which their term expires. This classification of directors could have the effect of increasing the length of time necessary to change the composition of a majority of our board of directors. In general, at least two annual meetings of stockholders will be necessary for stockholders to effect a change in a majority of the members of our board of directors.

Our board of directors currently consists of seven members. Messrs. Abraham, Berman and Wilson are Class I directors and will serve for one year. Messrs. Henderson and Korn are Class II directors and will serve for two years. Messrs. Fulgoni and Golden are Class III directors and will serve for three years.

Board Committees

Our board of directors has established an audit committee, a compensation committee and a nominating and governance committee.

Audit Committee

Our audit committee consists of Messrs. Berman, Korn and Wilson, with Mr. Korn serving as chairman. Our audit committee oversees our corporate accounting and financial reporting process and internal controls over financial reporting. Our audit committee evaluates the independent registered public accounting firm s qualifications, independence and performance; engages and provides for the compensation of the independent registered public accounting firm; approves the retention of the independent registered public accounting firm to perform any proposed permissible non-audit services; reviews our consolidated financial statements; reviews our critical accounting policies and estimates and internal controls over financial reporting; and discusses with management and the independent registered public accounting firm the results of the annual audit and the reviews of our quarterly consolidated financial statements. We believe that our audit committee members meet the requirements for independence and financial literacy under the current requirements of the Sarbanes-Oxley Act of 2002, The NASDAQ Global Market and SEC rules and regulations. In addition, the board of directors has determined that Mr. Korn is qualified as an audit committee financial expert within the meaning of SEC regulations. We have made this determination based on information received by our board of directors, including questionnaires provided by the members of our audit committee. We believe that our audit committee complies with the applicable requirements of the Sarbanes-Oxley Act of 2002, The NASDAQ Global Market and SEC rules and regulations. We intend to comply with future requirements to the extent they become applicable to us. We have adopted an audit committee charter. We expect that the committee will meet no less frequently than quarterly. Our audit committee has previously met approximately two to four times each year in connection with the annual audit of our financial statements.

Compensation Committee

Our compensation committee consists of Messrs. Berman, Henderson and Wilson, with Mr. Henderson serving as chair. Our compensation committee reviews and recommends policy relating to compensation and benefits of our officers and employees, including reviewing and approving corporate goals and objectives relevant to compensation of the Chief Executive Officer and other senior officers, evaluating the performance of these officers in light of those goals and objectives and setting compensation of these officers based on such evaluations. The compensation committee also administers the issuance of stock options and other awards under our stock plans. We believe that the composition of our compensation committee meets the requirements for independence under, and the functioning of our compensation committee complies with, any applicable requirements of the Sarbanes-Oxley Act of 2002, The NASDAQ Global Market and SEC rules and regulations. We intend to comply with future requirements to the extent they become applicable to us. We have adopted a compensation committee charter. We expect that the committee will meet at least once a year. Our compensation committee has previously met on an annual basis to review key compensation decisions.

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Nominating and Governance Committee

Our nominating and governance committee consists of Messrs. Golden, Henderson and Korn, with Mr. Golden serving as chairman, each of whom the board of directors has determined is an independent director under the rules of The NASDAQ Global Market. The nominating and governance committee recommends to the board of directors nominees for election as directors, and meets as necessary to review director candidates and nominees for election as directors.

Code of Business Conduct and Ethics

Our board of directors has adopted a code of business conduct and ethics, which establishes the standards of ethical conduct applicable to all directors, officers and employees of our company. The code addresses, among other things, conflicts of interest, compliance with disclosure controls and procedures and internal controls over financial reporting, corporate opportunities and confidentiality requirements. The audit committee is responsible for applying and interpreting our code of business conduct in situations where questions are presented to the committee.

Compensation Committee Interlocks and Insider Participation

None of the members of our compensation committee is an executive officer or employee of our company. None of our executive officers serves as a member of the compensation committee of any entity that has one or more executive officers serving on our compensation committee.

Director Compensation

None of our non-employee directors are currently compensated for service on the board of directors. We do, however, reimburse director expenses for attending meetings of the board of directors.

We previously granted equity awards for the purchase of our common stock to two of our present non-employee directors, William Henderson and Ronald Korn, upon their initial appointment to our board of directors. A warrant to purchase 100,000 shares of our common stock at an exercise price of $1.00 per share was issued on June 26, 2001 to Mr. Henderson, Such warrant shall terminate on the earlier of (i) June 26, 2011; (ii) the completion of this offering; or (iii) a change of control as defined in the warrant. In addition, Mr. Henderson was previously granted stock options for the purchase of 30,000 shares of our common stock at an exercise price of $0.50 per share on April 9, 2002 and for the purchase of 50,000 shares of our common stock at an exercise price of $0.90 per share on December 27, 2005. Mr. Korn was awarded stock options for the purchase of 100,000 shares of our common stock at an exercise price of $0.85 per share on November 25, 2005. The warrant for the purchase of 100,000 shares of our common stock issued to Mr. Henderson, the stock options for the purchase of 80,000 shares of common stock granted to Mr. Henderson and the stock option for the purchase of 100,000 shares of common stock granted to Mr. Korn remained outstanding as of December 31, 2006. Mr. Henderson subsequently exercised his warrant for 100,000 shares on May 15, 2007.

Upon the closing of this offering, our non-employee directors will be entitled to an annual grant of restricted stock having a value of $50,000 at the time of the grant. Non-employee directors will also be paid an annual cash retainer of $25,000 for serving on our board of directors, an additional annual cash retainer of $10,000 for serving as the chairman of our audit committee and $7,500 for serving as the chair of our compensation committee.

Our non-employee directors did not receive any compensation for their services as directors in 2006, and we did not incur stock-based compensation expense for any outstanding equity awards held by our non-employee directors during 2006.

Limitations on Director and Officer Liability and Indemnification

Our amended and restated certificate of incorporation as will be in effect upon completion of this offering limits the liability of our directors to the maximum extent permitted by Delaware law. Delaware law provides

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that directors of a corporation will not be personally liable for monetary damages for breach of their fiduciary duties as directors, except liability for:

- any breach of their duty of loyalty to the corporation or its stockholders;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- unlawful payments of dividends or unlawful stock repurchases or redemptions; or
- any transaction from which the director derived an improper personal benefit.

Our amended and restated certificate of incorporation and our amended and restated bylaws will provide that we are required to indemnify our directors and officers, in each case to the fullest extent permitted by Delaware law. Any repeal of or modification to our amended and restated certificate of incorporation and our amended and restated bylaws may not adversely affect any right or protection of a director or officer for or with respect to any acts or omissions of such director or officer occurring prior to such amendment or repeal. Our bylaws will also provide that we shall advance expenses incurred by a director or officer in advance of the final disposition of any action or proceeding, and permit us to secure insurance on behalf of any officer, director, employee or other agent for any liability arising out of his or her actions in connection with their services to us, regardless of whether our bylaws permit such indemnification.

We have entered into separate indemnification agreements with our directors and executive officers, in addition to the indemnification provided for in our bylaws. These agreements, among other things, provide that we will indemnify our directors and executive officers for certain expenses (including attorney s fees), judgments, fines, penalties and settlement amounts incurred by a director or executive officer in any action or proceeding arising out of such person s services as one of our directors or executive officers, or any other company or enterprise to which the person provides services at our request. We believe that these provisions and agreements are necessary to attract and retain qualified persons as directors and executive officers.

The limitation of liability and indemnification provisions that will be contained in our amended and restated certificate of incorporation and our amended and restated bylaws may discourage stockholders from bringing a lawsuit against our directors for breach of their fiduciary duty. They may also reduce the likelihood of derivative litigation against our directors and officers, even though an action, if successful, might benefit us and other stockholders. Further, a stockholder s investment may be adversely affected to the extent that we pay the costs of settlement and damage awards against directors and officers as required by these indemnification provisions. There is no pending litigation or proceeding involving one of our directors or executive officers as to which indemnification is required or permitted and we are not aware of any threatened litigation or proceeding that may result in a claim for indemnification.

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COMPENSATION DISCUSSION AND ANALYSIS

Our Philosophy

The objective of our compensation programs for employees is to retain and attract top talent. The plans are designed to reward, motivate and align employees to achieve business results and to reinforce accountability. In determining the compensation of senior executives, we are guided by the following key principles:

Competitive Compensation. Compensation should allow us to retain, attract, and motivate talented executives and be competitive with other opportunities that the executive may have. The competitive marketplace for our executives is not necessarily the same as for our business. Once we identify the type of employee needed, we then identify the competitive marketplace relevant to that employee based on the competencies and skills of that employee. For example, the marketplace for a chief financial officer may include all public companies, while the marketplace for a chief operating officer would focus on digital marketing intelligence providers. We seek to compensate our executives at levels that compare favorably with other opportunities in the executive s competitive marketplace.

Accountability for Business Performance. Compensation should be tied, in part, to financial performance, so that executives are held accountable through their compensation for contributions to our performance as a whole through the performance of the businesses for which they are responsible.

Accountability for Individual Performance. Compensation should be tied, in part, to the individual s performance to encourage and reflect individual contributions to our performance. Our board of directors considers individual performance as well as performance of the businesses and responsibility areas that an individual oversees, and weights these factors as appropriate in assessing a particular individual s performance.

Alignment with Stockholder Interests. Compensation should be tied, in part, to our financial performance through equity awards to align executives interests with those of our stockholders.

Independence. An independent committee of our board of directors should be, and is, responsible for reviewing and establishing the compensation for our Chief Executive Officer and Executive Chairman, and for reviewing and approving the compensation recommendations made by our Chief Executive Officer for all of our other executive officers.

Application of our Philosophy

Our executive compensation and benefit program aims to encourage our management team to continually pursue our strategic opportunities while effectively managing the risks and challenges inherent to our business. Specifically, we have created an executive compensation package that balances short versus long-term components, cash versus equity elements, and fixed versus contingent payments, in ways we believe are most appropriate to incentivize our senior management and reward them for achieving the following goals:

develop a culture that embodies a passion for our business, creative contribution and a drive to achieve established goals and objectives;

provide leadership to the organization in such a way as to maximize the results of our business operations;

- lead us by demonstrating forward thinking in the operation, development and expansion of our business;
- effectively manage organizational resources to derive the greatest value possible from each dollar invested; and
- take strategic advantage of the market opportunity to expand and grow our business.

Our executive compensation structure aims not only to compare favorably with other opportunities in an executive s competitive marketplace, but also to be fair relative to compensation paid to other professionals within our organization, relative to our short and long-term performance and relative to the value we deliver to our stockholders. We seek to maintain a performance-oriented culture and a compensation approach that rewards our executive officers when we achieve our goals and objectives, while putting at risk an appropriate portion of their compensation against the possibility that our goals and objectives may not be achieved. Overall, our approach is designed to relate the compensation of our executive officers to: the achievement of short and longer term goals and objectives; their willingness to challenge and improve existing policies and structures; and their capability to take advantage of unique opportunities and overcome difficult challenges within our business.

Role of Our Compensation Committee

Our compensation committee approves, administers and interprets our executive compensation and benefit policies, including our 1999 Stock Plan, our 2007 Equity Incentive Plan and our short-term compensation, long-term incentives and benefits programs. Our compensation committee is appointed by our board of directors, and consists entirely of directors who are outside directors for purposes of Section 162(m) of the Internal Revenue Code and non-employee directors for purposes of Rule 16b-3 under the Exchange Act. Our compensation committee is comprised of Messrs. Berman, Henderson and Wilson, and is chaired by Mr. Henderson.

Our compensation committee reviews and makes recommendations to our board of directors to ensure that our executive compensation and benefit program is consistent with our compensation philosophy and corporate governance guidelines and, subject to the approval of our board of directors, is responsible for establishing the executive compensation packages offered to our executive officers. We believe our executives base salary, target annual bonus levels and long-term incentive award values are set at levels that compare favorably with other opportunities in an executive s competitive marketplace.

Our compensation committee has taken the following steps to ensure that our executive compensation and benefit program is consistent with both our compensation philosophy and our corporate governance guidelines:

- regularly reviewed the performance of and the total compensation earned by or awarded to our Chief Executive Officer and Executive Chairman independent of input from them;

- examined on an annual basis the performance of our other named executive officers and other key employees with assistance from our Chief Executive Officer and Executive Chairman, and approved compensation packages that compare favorably in the executive s competitive marketplace; and

- regularly held executive sessions of the compensation committee meeting without management present.

Components of our Executive Compensation Program.

Our executive compensation program consists of three components: short-term compensation (including base salary and annual performance bonuses), long-term incentives and benefits.

Short-term Compensation

We utilize short-term compensation, including base salary, annual adjustments to base salary and annual performance bonuses, to motivate and reward our key executives in accordance with our performance-based program. Each individual s short-term compensation components are tied to an annual assessment of his or her progress against established objectives.

Base salary is used to recognize the experience, skills, knowledge and responsibilities required of each executive officer, as well as competitive market conditions. Base salary determinations are primarily guided by our objective to provide competitive compensation. In establishing the 2007 base salaries of the executive officers, our compensation committee and management took into account a number of factors, including the executive s seniority, position and functional role, level of responsibility and, to the extent such individual was employed by us for at least the prior six months, his or her accomplishments against personal and group objectives. For newly hired executives, we consider the base salary of the individual at his or her prior employment, any unique personal circumstances that motivated the executive to leave that prior position to

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join us and the compensation range for the particular role being filled. In addition, we consider the competitive market for corresponding positions within comparable geographic areas and industries.

The base salary of our executive officer group is reviewed on an annual basis and adjustments are made to reflect performance-based factors, as well as competitive conditions. Increases are considered within the context of our overall annual merit increase structure as well as individual and market competitive factors. We do not apply specific formulas to determine increases. Generally, executive officer salaries are adjusted effective the first quarter of each year based on a review of:

- their achievement of specific objectives established during the prior review;
- an assessment of their professional effectiveness, consisting of a portfolio of competencies that include leadership, commitment, creativity and organizational accomplishment; and
- their knowledge, skills and attitude, focusing on capabilities, capacity and the ability to drive results.

Annual performance bonuses for our executive officers are tied to the achievement of our annual company goals and objectives, functional area goals, and/or individual performance objectives. Annual performance bonuses are primarily guided by our objectives of accountability for individual and business performance. We set clearly defined goals for each executive officer, with an emphasis on quantifiable and achievable targets. A portion of each executive officer s bonus is clearly tied to the achievement of specific targets relative to the performance of the particular business segment or functional area for which they are responsible, with the remainder tied to similar targets relative to our overall financial performance. Individual awards under the program are based on a thorough review of the applicable performance results of the company, business, function or individual as compared to the applicable goals.

In 2006, Magid M. Abraham, our Chief Executive Officer, and Gian M. Fulgoni, our Executive Chairman of the Board of Directors, were our only named executive officers that had annual performance bonuses tied solely to quantitative factors. Both Dr. Abraham and Mr. Fulgoni s respective bonuses were based on a combination of total revenue and EBITDA achieved by the Company in 2006. Dr. Abraham received $117,273 in bonus for the year ended December 31, 2006, which amount represented 80% of his target bonus of $146,591. Mr. Fulgoni received $111,409, which amount also represented 80% of his target bonus of $139,261. Although for competitive reasons we do not publicly disclose the specific revenue or EBITDA targets that the Company must achieve for Messrs. Abraham and Fulgoni to earn their target bonus, we establish these revenue and EBITDA targets such that, if the Company and the officer perform as expected, there is a high likelihood that he will achieve 100% of the target bonus.

The annual performance bonuses for our other named executive officers in 2006 were based on qualitative factors several of which were the satisfactory completion of specific projects or initiatives. At the end of each fiscal year, the executive officers complete a self-assessment of their performance in the context of their bonus criteria. Dr. Abraham reviews these self-assessments and makes a recommendation to our compensation committee. Messrs. Green and Dale and Ms. Lin each received 100% of their respective target bonus amounts for 2006, which amounts were $47,019, $44,423 and $29,815, respectively. Ms. Huston did not receive a bonus payment for 2006 as her employment terminated in February 2006. Although for competitive reasons we do not publicly disclose the specific qualitative factors relating to target bonuses for our other executive officers, we establish these qualitative factors such that if they reasonably perform their duties, there is a high likelihood that they will achieve 100% of the target bonus.

Magid M. Abraham, our Chief Executive Officer, periodically reviews the performance of our executive officers on the basis noted above and recommends to the compensation committee any base salary changes or bonuses deemed appropriate.

For the 2005 and 2006 performance measurement years, executive bonuses were paid out in one installment during the month of February following the measurement year.

Long-term Compensation

Our long-term compensation program has historically consisted solely of stock options. Long-term equity based incentives are primarily guided by our objective of aligning executive compensation with the interests of

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our stockholders. Option grants made to executive officers are designed to provide them with incentive to execute their responsibilities in such a way as to generate long-term benefit to us and our stockholders. Through possession of stock options, our executives participate in the long-term results of their efforts, whether by appreciation of our company s value or the impact of business setbacks, either company-specific or industry based. Additionally, stock options provide a means of ensuring the retention of key executives, in that they are in almost all cases subject to vesting over an extended period of time.

Stock options are granted periodically, and are subject to vesting based on the executive s continued employment. Most options vest evenly over four years, beginning on the date of the grant. A portion of options granted to our executives vest according to defined performance milestones rather than solely based on time. Of the option grants and restricted stock currently outstanding and held by our executives, only the stock options held by Dr. Abraham and Mr. Fulgoni are subject to vesting based on performance milestones, as further described in the section entitled Executive Compensation Outstanding Equity Awards at December 31, 2006. These grants occurred in December 2003, and we have not used performance milestone-based vesting since then for any of our employees.

Upon joining us, each executive is granted an initial option award that is primarily based on competitive conditions applicable to the executive s specific position. In addition, the compensation committee considers the number of options owned by other executives in comparable positions within our company. We believe this strategy is consistent with the approach of other companies at the same stage of development in our industry and, in our compensation committee s view, is appropriate for aligning the interests of our executives with those of our stockholders over the long term.

Periodic awards to executive officers are made based on an assessment of their sustained performance over time, their ability to impact results that drive value to our stockholders and their organization level. Equity awards are not granted regularly or automatically to our executives on an annual basis. Magid Abraham, our Chief Executive Officer, periodically reviews the performance of our executive officers on the basis noted above and recommends to the compensation committee any equity awards deemed appropriate. The compensation committee reviews any such recommendations and presents them to our board of directors for approval, if appropriate.

During 2006, our board of directors granted stock options based upon the recommendations of our compensation committee. These grants were generally made during regularly scheduled board meetings. The exercise price of options was determined by our board of directors after taking into account a variety of factors, including the quality and growth of our management team and specific and general market comparables within our industry. In addition, our board of directors took into account the valuation opinion of our outside consultant, who provided valuations of our common stock at the end of each calendar quarter.

On March 25, 2007, we awarded an aggregate of 1,210,000 shares of restricted stock to our named executive officers based upon the recommendations of our compensation committee, taking into account the factors described above. Beginning in 2007, we expect to increase our use of restricted stock awards and reduce our use of stock options as a form of stock-based compensation.

Benefits

We provide the following benefits to our executive officers on the same basis as the benefits provided to all employees:

- health and dental insurance;
- life insurance;

- short-and long-term disability; and
- 401(k) plan.

These benefits are consistent with those offered by other companies and specifically with those companies with which we compete for employees.

Our Competitive Market

The market for experienced management with the knowledge, skills and experience our organization requires is highly competitive. Our objective is to attract and retain the most highly qualified executives to manage each of our business functions. In doing so, we draw upon a pool of talent that is highly sought after by other companies in our industry and those industries that also produce the requisite skills we seek. The competitive marketplace for our executives is not necessarily the same as for our business. Once we identify the type of employee needed, we then identify the competitive marketplace relevant to that employee based on the competencies and skills of that employee. For example, the marketplace for a chief financial officer may include all public companies, while the marketplace for a chief operating officer would focus on digital marketing intelligence providers. Upon identifying the target marketplace, we then solicit information through public data sources or through engaging consultants to assist us with an executive search. In the future, we intend to engage a compensation consultant to assist us in obtaining necessary information regarding compensation levels within a particular competitive marketplace.

We believe that our ability to offer significant upside potential through restricted stock and/or other equity instruments gives us a competitive advantage. Nonetheless, we must also offer cash compensation to our existing and prospective employees through base salaries and cash bonuses that are competitive in the marketplace and allow them to satisfy their day to day financial requirements.

We also compete on the basis of our vision of future success, our culture and company values and the excellence of our management personnel. In all of these areas, we compete with other market research and technology companies.

Total Compensation

We intend to continue our strategy of compensating our named executive officers at competitive levels for each type of executive, with the opportunity to impact their total annual compensation through performance-based incentive programs that include both cash and equity elements. Our approach to total executive compensation is designed to drive results that maximize our financial performance and deliver value to our stockholders. In light of our compensation philosophy, we believe that the total compensation package for our executives should continue to consist of base salary, annual cash performance bonus and long-term equity-based incentives, reflecting our key compensation principles of competitive compensation, accountability for individual and business performance, and alignment with stockholder interests, respectively. We do not consider benefits to be a key element in attracting executive officers, and we typically offer largely the same benefits to our executive officers. Historically, we have typically offered a combination of short-term and long-term compensation to suit our executives preferences. Certain of our executives who joined us earlier in our history preferred to accept more long-term compensation in the form of stock options, as the potential return was higher at that stage and our ability to fund short-term cash compensation was more limited. At the same time, certain of our executives have preferred greater short-term compensation and reduced long-term compensation. As we have become more profitable, our ability to attract executives through short-term compensation has increased. As we transition to becoming a public company, we expect that our decisions regarding the relationship among our elements of compensation will become less dependent upon our stage as a growing company and more dependent upon our key compensation principles.

Evolution of our Compensation Approach

Our compensation approach is necessarily tied to our stage of development as a company. Accordingly, the specific direction, emphasis and components of our executive compensation program will continue to evolve as our company and its underlying business strategy continue to grow and develop. For example, we intend to reduce our executive compensation program s emphasis on stock options as a long-term incentive component in favor of other forms of equity compensation such as restricted stock awards. Similarly, we may revise how we measure senior executive performance to take into account the unique requirements of being a public company, including, but not limited to, strict compliance with the standards of the Sarbanes Oxley Act. In addition, we may engage a compensation consultant to assist our compensation committee in continuing to evolve our executive compensation program, and we may look to programs implemented by comparable public companies in refining our compensation approach.

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EXECUTIVE COMPENSATION

Summary Compensation Table

The following table sets forth the summary information concerning compensation during 2006 for the following persons: (i) our chief executive officer, (ii) our current chief financial officer and any individual serving as our chief financial officer during 2006 and (iii) the three most highly compensated of our other executive officers who received compensation during 2006 of at least $100,000 and who were executive officers on December 31, 2006. We refer to these persons as our named executive officers elsewhere in this prospectus.

Name and Principal Position	Year	Salary	Bonus	Option Awards(1)	All Other Compensation	Total
Magid M. Abraham, Ph.D. *President, Chief Executive Officer and Director*	2006	$ 297,612	$ 117,273		$ 3,072(2)	$ 417,957

100

0.7

BB-

Moderate

5.1
1.928 to 2.620

0.4

2.25

45.4

100

0.4

BB-

5.2
2.621 to 3.579

0.7

3.05

34.5

100

0.7

B+

5.3
3.580 to 4.914

0.3

4.20

59.7

167

0.5

B+

Significant

6.1
4.915 to 6.718

0.3

5.75

69.7

200

0.6

B

6.2
6.719 to 8.860

0.2

7.85

72.7

250

0.5

B-

High

7.1
8.861 to 11.402

0.9

10.00

49.7

211

1.9

B-

7.2
11.403 to 15.000

0.2

13.00

52.5

200

0.4

CCC+

Special management

8.1
15.001 to 22.000

-

-

-

-

-

CCC

8.2

22.001 to 50.000

-

-

-

-

-

CCC-

8.3
50.001 to 99.999

-

-

-

-

-

CC to C

Default4

9/10
100.000

0.2

100.00

47.0

50

0.1

Default

At 31 December 2013

130.0

0.46

33.6

22

28.0

For footnotes, see page 50.

Table 30c: Wholesale IRB exposure - by obligor grade1 - Corporates5 (continued)

	CRR	PD range %	Exposure value2 US$bn	Average PD3 %	Average LGD3 %	RWA density3 %	RWAs US$bn	Mapped external rating
Default risk								
Minimal	0.16	0.000 to 0.010	-	-	-	-	-	
	1.1	0.011 to 0.028	11.5	0.03	43.6	16	1.8	AAA to AA
	1.2	0.029 to 0.053	43.0	0.04	30.4	13	5.6	AA-
Low	2.1	0.054 to 0.095	70.7	0.07	32.8	18	12.5	A+ to A
	2.2	0.096 to 0.169	91.3	0.13	32.8	25	22.9	A- BBB+
Satisfactory	3.1	0.170 to 0.285	82.9	0.22	37.0	38	31.5	BBB+
	3.2	0.286 to 0.483	71.9	0.37	39.7	53	38.2	BBB
	3.3	0.484 to 0.740	71.1	0.63	35.0	60	42.7	BBB-
Fair	4.1	0.741 to 1.022	47.4	0.87	36.1	70	33.1	BB+

	4.2	1.023 to 1.407	33.0	1.20	37.9	81	26.7	BB
	4.3	1.408 to 1.927	32.6	1.65	40.3	101	32.8	BB-
Moderate	5.1	1.928 to 2.620	22.6	2.24	38.0	100	22.6	BB-
	5.2	2.621 to 3.579	12.8	3.07	40.8	116	14.9	B+
	5.3	3.580 to 4.914	11.6	4.16	38.7	121	14.0	B
Significant	6.1	4.915 to 6.718	4.7	5.74	36.9	123	5.8	B-
	6.2	6.719 to 8.860	3.6	7.85	39.7	158	5.7	B-
High	7.1	8.861 to 11.402	1.7	10.03	32.9	139	2.5	CCC+
	7.2	11.403 to 15.000	0.9	13.00	38.0	178	1.6	CCC+
Special management	8.1	15.001 to 22.000	0.7	19.01	34.5	175	1.4	CCC
	8.2	22.001 to 50.000	0.3	36.00	31.2	167	0.5	CCC- to CC
	8.3	50.001 to 99.999	0.3	75.00	45.1	133	0.4	C
Default4	9/10	100.000	6.3	100.00	40.8	81	5.1	Default
At 31 December 2014			620.9	1.85	36.0	52	322.3	
Default risk								
Minimal	0.16	0.000 to 0.010	-	-	-	-	-	

	1.1	0.011 to 0.028	12.5	0.03	42.7	15	1.9	AAA to AA-
	1.2	0.029 to 0.053	30.1	0.04	37.5	14	4.2	A+
Low	2.1	0.054 to 0.095	55.7	0.07	39.0	21	11.7	A
	2.2	0.096 to 0.169	64.5	0.13	41.5	31	20.3	A-
Satisfactory	3.1	0.170 to 0.285	71.3	0.22	39.9	40	28.7	BBB+
	3.2	0.286 to 0.483	64.2	0.37	38.8	52	33.1	BBB to BBB-
	3.3	0.484 to 0.740	49.1	0.63	37.9	64	31.6	BBB-
Fair	4.1	0.741 to 1.022	32.8	0.87	36.9	73	23.8	BB+
	4.2	1.023 to 1.407	28.1	1.20	37.1	81	22.8	BB
	4.3	1.408 to 1.927	29.3	1.65	36.3	89	26.0	BB-
Moderate	5.1	1.928 to 2.620	20.2	2.25	33.9	93	18.8	BB-
	5.2	2.621 to 3.579	12.9	3.05	38.5	112	14.6	B+
	5.3	3.580 to 4.914	9.8	4.20	35.5	115	11.3	B+
Significant	6.1	4.915 to 6.718	4.4	5.75	33.7	125	5.5	B
	6.2	6.719 to 8.860	3.1	7.85	38.0	158	4.9	B-

High	7.1	8.861 to 11.402	2.1	10.00	32.6	148	3.1	B-
	7.2	11.403 to 15.000	0.7	13.00	28.9	171	1.2	CCC+
Special management	8.1	15.001 to 22.000	1.0	19.00	35.5	190	1.9	CCC
	8.2	22.001 to 50.000	0.4	36.00	26.8	150	0.6	CCC-
	8.3	50.001 to 99.999	0.3	75.00	34.5	100	0.3	CC toC
Default4	9/10	100.000	7.1	100.00	36.2	41	2.9	Default
At 31 December 2013			499.6	2.32	38.5	54	269.2	

1 See glossary for definition of obligor grade.

2 Central governments and central banks exposure value includes US$1.2bn (2013: US$1.5bn) in undrawn commitments, institutions exposure value includes US$15.4bn (2013: US$12.7bn) and corporates exposure value includes US$358.2bn (2013: U$313.1bn).

3 Average PD, average LGD and RWA density percentages represent an exposure weighted average.

4 There is a requirement to hold additional capital for unexpected losses on defaulted exposures where LGD exceeds best estimate of EL. As a result, in some cases, RWAs arise for exposures in default.

5 Excludes specialised lending exposures subject to the supervisory slotting approach (EAD: US$30.5bn; RWA: US$23.0bn).

6 The top band of the wholesale CRR master scale is not available to entities in the corporates exposure class, but restricted to the strongest central governments, central banks and institutions.

Key points

Central Governments and Central Banks

· The decrease in CRR 1.1 has been primarily driven by the sovereign rating downgrades in Middle East and North Africa to CRR 1.2 and reduced government debt in Asia.

· The movements in CRR 1.2 and CRR 2.1 bands are primarily driven by a sovereign rating upgrade in Asia.

Institutions

· LGD weightings have been impacted by the introduction of LGD floors applied to institutions.
· The movement in CRR 1.2 has been primarily driven by the CRD IV requirement to report exposure gross of any cash collateral and increased lending in Asia.

Corporates

· The increased exposure across Corporate CRR bandings was primarily driven by the CRD IV requirement to report exposure gross of any cash collateral. The additional increase in CRR 1.2, CRR 3.1, CRR 3.2, CRR 3.3 and CRR 4.1 reflects higher Corporate lending, including term and trade-related lending in Asia, Europe and North America.
· This increase in exposure is principally in the upper PD bandings resulting in the decrease in average PD.
· Average LGDs remain broadly consistent overall, with a decrease resulting from the inclusion of cash collateral in the LGD calculation for exposures under CRD IV, offset by an increase due to the introduction of LGD floors applied to certain corporates.

To view charts in PDF format please click on the link below:

http://www.rns-pdf.londonstockexchange.com/rns/5403F_-2015-2-22.pdf

Wholesale exposures by CRR Band

Wholesale 2014

Wholesale 2013

Central governments and central banks

Institutions

Corporates

Retail risk rating systems

Owing to the different country-level portfolio performance characteristics and loss history, there are no global models for our retail portfolios. Our retail models are developed at a local level, based on portfolio behaviour and observed defaults. Across the Group, we maintain over 1,000 retail risk predictive scorecards and models. Of these, just under 300 are used with the PRA's approval under our IRB permission, the remainder being application scorecards, behavioural scorecards, or forecasting models.

We classify approximately 40% of the total number of retail IRB models as constituting globally or regionally material risk rating systems, based on the criteria set out on page 33 and taking account of strategic importance to the Group. These material risk rating systems represented approximately 86% of our total retail IRB RWAs of US$106bn as of 31 December 2014.

The ten most material risk rating systems based on the above criteria, for which we disclose details of modelling methodology in table 31 below and performance data in table 37, represented RWAs of approximately US$74bn or

70% of the total retail IRB RWAs, the majority being attributable to the five risk rating systems for residential mortgages, our most material retail exposure class.

All newly adopted IRB models for retail portfolios, irrespective of size, require PRA approval. For changes to existing IRB models, a PRA approval process applies to all but a list of de minimis exemptions representing an immaterial percentage of total Group credit risk RWAs. This approval process sets various quantitative and qualitative thresholds to ensure that all significant model changes go forward for approval.

When developing retail models, segmentation based on risk characteristics is often adopted to enhance the models' discrimination and accuracy. The majority of our retail models are designed for a particular product or group of products in a specific country. We have developed and issued global internal model governance, development, validation and monitoring standards to ensure that locally developed models adhere, as far as possible, to consistent global standards. These permit specific variances in model approach, depending on local

regulatory, legal or data requirements, which are used to determine and predict the risks in these portfolios.

Our models incorporate conservatism where required under regulatory rules. Additional levels of conservatism, varying from region to region, may arise from a methodological choice of ours or from a specific regulatory intervention, depending on the local assessment of the risk factors by us and the regulatory authorities. Regulators may additionally impose 'floor' values for various metrics where data is scarce.

Our PD models are developed using statistical estimation based on a minimum of five years of historical data. The modelling approach is typically inherently TTC or, where models are developed based on a PIT approach, as in the UK, the model outputs become effectively TTC through the application of buffer or model adjustments as agreed with the PRA.

Our retail EAD models are also developed using at least five years of historical observations and typically adopt one of two approaches:

· for closed-end products without the facility for additional drawdowns, EAD is estimated as the outstanding balance of accounts at the time of observation; or

· EAD for products with the facility for additional drawdowns is estimated as the outstanding balance of accounts at the time of observation plus a CCF applied to the undrawn portion of the facility.

Our approach to LGD estimates has more variation, particularly in respect of the downturn period calculation that they generally include. For instance, UK mortgage models use a regulatory-defined downturn based on a minimum 40% decline in house prices from peak to trough.

In Hong Kong and the US, the downturn LGD for the mortgage model is defined to be the period when historical default rates and property price declines were at their most severe. This was observed in 2003-2004 in Hong Kong when it experienced the Severe Acute Respiratory Syndrome. In the US, this coincided with the US recession and subprime mortgage crisis covering the periods 2003 to 2008.

Table 31: Material Retail IRB risk rating systems

Portfolio	CRD IV asset class	RWA US$bn	Component model	Number of material component models	Model description and methodology	Number of years loss data1	Applicable Pillar 1 regulatory thresholds

							and overlays
			PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	7-10	PD floor of 0.03%
UK HSBC residential mortgages	Retail - secured by mortgages on immovable property non-SME	5.86	LGD	1	Statistical estimates of loss and probability of possession in combination with the workout process and using the 1990's recession in benchmarking the downturn LGD.	> 10	LGD floor of 10% at portfolio level
			EAD	1	Statistical model based on historical data and uses balance at observation and expected number of months to default.	7-10	EAD must at least be equal to current balance
UK HSBC credit cards	Retail - qualifying revolving	2.24	PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	7-10	PD floor of 0.03%
			LGD	1	Statistical model based on forecasting the amount of expected future recoveries.	7-10	
			EAD	1	Statistical model which derives a credit conversion factor to determine the proportion of undrawn limit to	7-10	EAD must at least be equal to current balance

					be added to the balance at observation.		
			PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	7-10	PD floor of 0.03%
UK HSBC personal loans	Retail - other non-SME	2.45	LGD	1	Statistical model based on forecasting the amount of expected future recoveries.	7-10	
			EAD	1	Rule-based calculation based on current balance which continues to be a conservative estimate for EAD.	7-10	EAD must at least be equal to current balance
UK business banking	Retail - other SME	4.50	PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	7-10	PD floor of 0.03%
			LGD	2	Two sets of models - one for secured and another for unsecured exposures. The secured model uses the value to loan as a key component for estimation while the unsecured model estimates the amount of future recoveries and undrawn portion.	7-10	
			EAD	1		7-10	

					Statistical model using segmentation according to limit and utilisation and estimation of the undrawn exposure.		EAD must at least be equal to current balance
			PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	> 10	PD floor of 0.03%
Hong Kong HSBC personal residential mortgages2	Retail - secured by mortgages on immovable property non-SME	3.70	LGD	1	Statistical model based on estimate of loss incurred over a recovery period derived from historical data with downturn LGD based on the worst observed default rate.	> 10	LGD floor of 10% at portfolio level
			EAD	1	Rule-based calculation based on current balance which continues to be a conservative estimate for EAD.	> 10	EAD must at least be equal to current balance
Hong Kong HSBC credit cards	Retail - qualifying revolving	2.90	PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	> 10	PD floor of 0.03%
			LGD	1	Statistical model based on forecasting the amount of expected future recoveries.	> 10	
			EAD	1	Statistical model which derives a	> 10	EAD must at least be

					credit conversion factor to determine the proportion of undrawn limit to be added to the balance at observation.		equal to current balance

Portfolio	CRD IV asset class	RWA US$bn	Component model	Number of material component models	Model description and methodology	Number of years loss data1	Applicable Pillar 1 regulatory thresholds and overlays
Hong Kong HSBC personal instalment loans	Retail - other non-SME	1.22	PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	> 10	PD floor of 0.03%
			LGD	1	Statistical model based on forecasting the amount of expected future recoveries.	> 10	
			EAD	1	Rule-based calculation based on current balance which continues to be a conservative estimate for EAD.	> 10	EAD must at least be equal to current balance
			PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	> 10	PD floor of 0.03%

			LGD	1	Statistical model based on identifying the main risk drivers of loss and recovery and grouping them into homogeneous pools. Downturn LGD is derived based on the peak default rate observed while additional assumptions and estimations are done on incomplete workouts.	> 10	LGD floor of 10% at portfolio level 10% uplift on the total LGD for first lien portfolio LGD floor at the segment level based on the value notified to the PRA and ranges from c.60% to c.98%
			EAD	1	Rule-based calculation based on current balance which continues to be a conservative estimate for EAD.	> 10	EAD must at least be equal to current balance
US Mortgage Services first lien3	Retail - secured by mortgages on immovable property non-SME	13.3	PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	> 10	PD floor of 0.03%
			LGD	1	Statistical model based on identifying the main risk drivers of loss and recovery and grouping them into homogeneous pools. Downturn LGD is derived based on the peak	> 10	LGD floor of 10% at portfolio level 10% uplift on the total LGD for first lien portfolio LGD floor at the segment level based on the value notified to the PRA and

					default rate observed while additional assumptions and estimations are done on incomplete workouts.	ranges from c.60% to c.98%
			EAD	1	Rule-based calculation based on current balance which continues to be a conservative estimate for EAD.	> 10EAD must at least be equal to current balance
US HSBC Mortgage Corporation first lien3	Retail - secured by mortgages on immovable property non-SME	9.0	PD	1	Statistical model built on internal behavioural data and bureau information, and calibrated to a long-run default rate.	> 10PD floor of 0.03% Uplift in RWA and EL based on comparison of outputs between existing and new models
			LGD	1	Statistical model based on identifying the main risk drivers of loss and recovery and grouping them into homogeneous pools. Downturn LGD is derived based on the peak default rate observed while additional assumptions and estimations are done on incomplete workouts.	> 10LGD floor of 10% at portfolio level Uplift in RWA and EL based on comparison of outputs between existing and new models
			EAD	1	Rule-based calculation based on current balance which	> 10EAD must at least be equal to current balance

	continues to be a conservative estimate for EAD.	Uplift in RWA and EL based on comparison of outputs between existing and new models

1 Defined as the number of years from the data period used for model development up to the present.

2 The Hong Kong Monetary Authority also introduced a 15% risk weight floor for all residential mortgages granted after 22 February 2013 in Hong Kong. This risk weight floor is also reflected in Group reported numbers.

3 In US mortgage business, first lien is a primary claim on a property which takes precedence over all subsequent claims and will be paid first from the proceeds in case of the property's foreclosure sale.

In December 2013, the PRA approved our use of a new set of models (referred to as Gen2 models) for the CML portfolios, subject to certain conditions with regard to LGD floors and regular assessment of the capital difference in applying the US instead of the PRA rules, mainly on the definition of default used for modelling.

For the HSBC Mortgage Corporation first lien portfolio, we continue to include agreed adjustments to the existing model outputs based on a new set of models which are yet to be approved by the PRA.

Table 32a below sets out the exposure-weighted average PDs by retail exposure class while table 32b below provides the exposure value, exposure-weighted average PDs and LGDs, RWA density and RWAs for our most material residential mortgages risk rating systems.

In table 32b, the regulatory LGD and PD floors of 10% and 0.03%, respectively, are included. In this table, the UK HSBC residential mortgages include the HSBC branded portfolios of HSBC Bank plc but not those of First Direct, Hong Kong residential mortgages consist of HSBC and Hang Seng portfolios, and the US residential mortgages cover the CML and the US HSBC Mortgage Corporation portfolios. The PD and LGD values in the US residential mortgages are before the quantitative adjustment due to the existing deficiencies of the US HSBC Mortgage Corporation Gen1 model. This quantitative adjustment is applied at the total portfolio RWA and EL levels.

Within table 32b, the RWAs and other Basel metrics have decreased in 2014 due to the increasing house prices in the UK and the continued sale of defaulted assets and improving economic conditions in the US. On the other hand, the implementation of the 15% risk weight floor for new residential mortgages in 2014 increased the RWAs and RWA density in Hong Kong.

Tables 33 and 34 show IRB exposures by exposure sub-class and portfolio quality bands: at Group level by internal PD band and by geographic region using a composite EL measure, respectively.

In table 33, band seven has lower RWAs because, as assets approach and go into default, our capital requirements are increasingly reflected in an EL deduction from capital, rather than a direct RWA

impact.

Table 32a: Retail IRB portfolio analysis

	Europe	Asia	North America	Total
	%	%	%	%
At 31 December 2014				
Exposure-weighted average PD				
Retail - secured by mortgages on immovable property non-SME	0.98	1.00	11.54	3.06
Retail - secured by mortgages on immovable property SME	8.81	0.76	-	7.06
Retail - qualifying revolving	1.41	1.09	1.74	1.30
Retail - other SME	10.09	0.12	3.75	9.73
Retail - other non-SME	1.90	1.76	7.54	2.68
Exposure-weighted average LGD				
Retail - secured by mortgages on immovable property non-SME	13.5	12.1	51.5	20.5
Retail - secured by mortgages on immovable property SME	19.0	11.1	-	17.5
Retail - qualifying revolving	84.5	100.2	90.1	91.3
Retail - other SME	48.7	9.1	61.0	49.0
Retail - other non-SME	22.0	22.8	77.7	30.0

Table 32b: Retail IRB exposures secured by mortgages on immovable property (non-SME)

	Exposure value	Average PD	Average LGD	RWA density	RWAs
	US$bn	%	%	%	US$bn
At 31 December 2014					
Total Retail IRB exposures secured by mortgages on immovable property (non-SME)	288.9	3.06	20.5	25	71.6
Of which:					
- US first lien residential mortgages	37.3	14.83	56.4	136	50.9
- UK HSBC residential mortgages	98.3	0.93	15.5	6	5.9
- Hong Kong residential mortgages	56.3	0.78	10.1	10	5.8
At 31 December 2013					
Total Retail IRB exposures secured on real estate property	310.7	4.02	20.1	34	105.4
Of which:					
- US first lien residential mortgages	42.8	18.13	59.6	176	75.3
- UK HSBC residential mortgages	104.4	1.11	16.4	7	7.3
- Hong Kong residential mortgages	52.1	0.74	10.1	7	3.8

Table 33: Retail IRB exposure - by internal PD band

	PD range	Exposure value1	Average PD2	Average LGD2	RWA density2	RWAs
	%	US$bn	%	%	%	US$bn
At 31 December 2014						
Secured by mortgages on immovable property SME						
Band 1	0.000 to 0.483	0.5	0.10	11.9	0	0.0
Band 2	0.484 to 1.022	0.6	0.80	16.8	17	0.1
Band 3	1.023 to 4.914	1.5	2.45	18.3	20	0.3
Band 4	4.915 to 8.860	0.2	6.94	23.0	50	0.1
Band 5	8.861 to 15.000	0.1	11.25	26.4	0	0.0
Band 6	15.001 to 50.000	0.1	25.01	18.8	100	0.1
Band 7	50.001 to 100.000	0.1	100.00	16.8	0	0.0
		3.1	7.06	17.5	21	0.6
Secured by mortgages on immovable property Non-SME						
Band 1	0.000 to 0.483	219.7	0.12	15.2	6	12.1
Band 2	0.484 to 1.022	27.2	0.69	27.5	31	8.5
Band 3	1.023 to 4.914	24.1	2.01	36.2	82	19.8
Band 4	4.915 to 8.860	5.8	5.89	52.0	221	12.8
Band 5	8.861 to 15.000	2.2	12.31	36.7	200	4.4
Band 6	15.001 to 50.000	3.2	23.72	57.7	378	12.1
Band 7		6.7	97.17	59.4	28	1.9

	50.001 to 100.000					
		288.9	3.06	20.5	25	71.6
Qualifying revolving retail exposures						
Band 1	0.000 to 0.483	47.8	0.12	91.9	6	3.1
Band 2	0.484 to 1.022	6.6	0.71	91.3	29	1.9
Band 3	1.023 to 4.914	9.1	2.26	89.8	65	5.9
Band 4	4.915 to 8.860	1.4	6.64	87.8	136	1.9
Band 5	8.861 to 15.000	0.5	11.06	89.1	200	1.0
Band 6	15.001 to 50.000	0.5	24.44	90.3	260	1.3
Band 7	50.001 to 100.000	0.3	89.52	64.5	67	0.2
		66.2	1.30	91.3	23	15.3
Other SME						
Band 1	0.000 to 0.483	1.8	0.29	57.1	17	0.3
Band 2	0.484 to 1.022	2.3	0.74	46.0	30	0.7
Band 3	1.023 to 4.914	6.3	2.56	49.4	52	3.3
Band 4	4.915 to 8.860	1.5	6.68	45.7	60	0.9
Band 5	8.861 to 15.000	0.6	11.00	52.7	67	0.4
Band 6	15.001 to 50.000	0.5	24.99	54.1	100	0.5
Band 7	50.001 to 100.000	0.9	99.27	37.9	11	0.1
		13.9	9.73	49.0	45	6.2
Other non-SME						
Band 1	0.000 to 0.483	27.0	0.19	25.7	11	3.0
Band 2	0.484 to 1.022	6.3	0.71	33.3	30	1.9
Band 3	1.023 to 4.914	11.3	1.98	30.1	42	4.7
Band 4		0.9	7.24	60.6	100	0.9

	4.915 to 8.860					
Band 5	8.861 to 15.000	0.5	12.25	71.2	160	0.8
Band 6	15.001 to 50.000	0.6	28.20	63.4	150	0.9
Band 7	50.001 to 100.000	0.7	95.81	66.5	29	0.2
		47.3	2.68	30.0	26	12.4
Total retail						
Band 1	0.000 to 0.483	296.8	0.13	28.8	6	18.5
Band 2	0.484 to 1.022	43.0	0.70	39.0	30	13.1
Band 3	1.023 to 4.914	52.3	2.13	45.2	65	34.0
Band 4	4.915 to 8.860	9.8	6.27	56.2	169	16.6
Band 5	8.861 to 15.000	3.9	11.91	51.0	169	6.6
Band 6	15.001 to 50.000	4.9	24.47	60.7	304	14.9
Band 7	50.001 to 100.000	8.7	97.05	57.3	28	2.4
		419.4	2.99	33.7	25	106.1

	PD range	Exposure value	Average PD2	Average LGD2	RWA density2	RWAs
	%	US$bn	%	%	%	US$bn
At 31 December 2013						
Secured on real estate property						
Band 1	0.000 to 0.483	215.1	0.12	14.2	4	9.3
Band 2	0.484 to 1.022	42.2	0.65	23.4	29	12.2
Band 3	1.023 to 4.914	30.0	2.30	34.9	106	31.9
Band 4	4.915 to 8.860	5.1	5.91	54.3	308	15.7
Band 5	8.861 to 15.000	3.6	12.25	44.6	300	10.8
Band 6		4.9	24.16	50.2	445	21.8

	15.001 to 50.000					
Band 7	50.001 to 100.000	9.8	96.17	49.6	38	3.7
		310.7	4.02	20.1	34	105.4
Qualifying revolving retail exposures						
Band 1	0.000 to 0.483	47.9	0.12	90.7	6	2.9
Band 2	0.484 to 1.022	6.3	0.70	91.3	29	1.8
Band 3	1.023 to 4.914	9.5	2.18	88.7	62	5.9
Band 4	4.915 to 8.860	1.6	6.59	85.8	131	2.1
Band 5	8.861 to 15.000	0.7	10.90	84.9	157	1.1
Band 6	15.001 to 50.000	0.5	27.63	86.9	240	1.2
Band 7	50.001 to 100.000	0.4	88.27	78.4	100	0.4
		66.9	1.40	90.2	23	15.4
SMEs						
Band 1	0.000 to 0.483	2.6	0.25	38.3	19	0.5
Band 2	0.484 to 1.022	2.8	0.76	30.4	29	0.8
Band 3	1.023 to 4.914	8.1	2.64	40.5	57	4.6
Band 4	4.915 to 8.860	2.3	6.71	37.8	61	1.4
Band 5	8.861 to 15.000	0.8	11.08	46.3	88	0.7
Band 6	15.001 to 50.000	0.7	25.47	48.4	114	0.8
Band 7	50.001 to 100.000	1.3	99.27	34.9	8	0.1
		18.6	10.63	38.5	48	8.9
Other retail						
Band 1	0.000 to 0.483	24.6	0.20	17.7	9	2.1
Band 2	0.484 to 1.022	8.1	0.70	30.6	27	2.2
Band 3	1.023 to 4.914	11.4	1.98	28.6	39	4.5

Band 4	4.915 to 8.860	1.0	7.07	41.4	70	0.7
Band 5	8.861 to 15.000	0.5	11.76	55.7	100	0.5
Band 6	15.001 to 50.000	0.6	27.91	35.5	100	0.6
Band 7	50.001 to 100.000	0.6	93.52	56.1	67	0.4
		46.8	2.64	24.3	24	11.0
Total retail						
Band 1	0.000 to 0.483	290.2	0.12	27.3	5	14.8
Band 2	0.484 to 1.022	59.4	0.67	32.0	29	17.0
Band 3	1.023 to 4.914	59.0	2.26	43.1	79	46.9
Band 4	4.915 to 8.860	10.0	6.32	54.2	199	19.9
Band 5	8.861 to 15.000	5.6	11.88	50.6	234	13.1
Band 6	15.001 to 50.000	6.7	24.88	51.3	364	24.4
Band 7	50.001 to 100.000	12.1	96.13	49.2	38	4.6
		443.0	3.76	31.9	32	140.7

1 Secured by mortgages on immovable property - SME exposure value includes nil in undrawn commitments, secured by mortgages on immovable property - non-SME exposure value includes US$17.9bn, qualifying revolving retail exposures exposure value includes US$93.0bn, other SME exposure value includes US$4.4bn and other non-SMEexposure value includes US$14.4bn.

2 Average PD, average LGD and RWA density percentages represent exposure-weighted averages.

To view charts in PDF format please click on the link below:

http://www.rns-pdf.londonstockexchange.com/rns/5403F_-2015-2-22.pdf

Retail exposures by internal PD band

2014

2013

Key points

Secured by mortgages on immovable property

· Favourable shifts in PD bands are driven by the US run-off portfolio, due to book quality improvement driven by continued run-off that resulted in an improvement in the residual portfolio.

· The re-classification of part of the mortgage portfolio in North America has driven the movement between secured by mortgages on immovable property and other non-SME.

The possible variation between jurisdictions' definitions underlying retail PD and LGD diminishes the usefulness of these measures as comparators for the purposes of global retail portfolio management. To address this, we also maintain an EL scale for retail business, combining obligor and facility/product risk factors in a composite measure of PD and LGD. This scale, summarised in the table below, enables the diverse risk profiles of retail portfolios across the Group to be assessed using a common denominator instead of their disparate PD and LGD measures.

Table 34: Retail IRB exposure - by region1

	Exposure value			
	Europe US$bn	Asia US$bn	North America US$bn	Total exposure US$bn
Secured by mortgages on immovable property SME				
Expected loss band				
- less than 1%	1.8	0.7	-	2.5
- greater than or equal to 1% and less than 5%	0.5	-	-	0.5
- greater than or equal to 5% and less than 10%	-	-	-	-
- greater than or equal to 10% and less than 20%	-	-	-	-
- greater than or equal to 20% and less than 40%	-	-	-	-
- greater than or equal to 40% or exposures in default	0.1	-	-	0.1
	2.4	0.7	-	3.1
Secured by mortgages on immovable property non-SME				
Expected loss band				
- less than 1%	142.2	87.6	35.9	265.7
- greater than or equal to 1% and less than 5%	0.7	0.2	10.7	11.6
- greater than or equal to 5% and less than 10%	0.2	-	1.9	2.1
- greater than or equal to 10% and less than 20%	0.1	-	2.0	2.1
- greater than or equal to 20% and less than 40%	-	-	0.7	0.7
	0.9	0.4	5.4	6.7

- greater than or equal to 40% or exposures in default				
	144.1	88.2	56.6	288.9
Qualifying revolving retail exposures				
Expected loss band				
- less than 1%	29.4	23.4	3.2	56.0
- greater than or equal to 1% and less than 5%	4.4	3.1	0.7	8.2
- greater than or equal to 5% and less than 10%	0.6	0.4	0.1	1.1
- greater than or equal to 10% and less than 20%	0.2	0.3	-	0.5
- greater than or equal to 20% and less than 40%	0.1	0.1	-	0.2
- greater than or equal to 40% or exposures in default	0.2	-	-	0.2
	34.9	27.3	4.0	66.2
Other SME				
Expected loss band				
- less than 1%	6.3	0.1	0.4	6.8
- greater than or equal to 1% and less than 5%	5.1	-	0.2	5.3
- greater than or equal to 5% and less than 10%	0.6	-	-	0.6
- greater than or equal to 10% and less than 20%	0.2	-	-	0.2
- greater than or equal to 20% and less than 40%	0.1	-	-	0.1
- greater than or equal to 40% or exposures in default	0.9	-	-	0.9
	13.2	0.1	0.6	13.9
Other non-SME				
Expected loss band				
- less than 1%	32.6	5.4	3.9	41.9
- greater than or equal to 1% and less than 5%	1.5	0.5	1.6	3.6
- greater than or equal to 5% and less than 10%	0.2	0.1	0.3	0.6
- greater than or equal to 10% and less than 20%	-	-	0.4	0.4
- greater than or equal to 20% and less than 40%	-	-	0.2	0.2
- greater than or equal to 40% or exposures in default	0.3	-	0.3	0.6
	34.6	6.0	6.7	47.3
Total retail				
Expected loss band				
- less than 1%	212.3	117.2	43.4	372.9
- greater than or equal to 1% and less than 5%	12.2	3.8	13.2	29.2
- greater than or equal to 5% and less than 10%	1.6	0.5	2.3	4.4
- greater than or equal to 10% and less than 20%	0.5	0.3	2.4	3.2
- greater than or equal to 20% and less than 40%	0.2	0.1	0.9	1.2
- greater than or equal to 40% or exposures in default	2.4	0.4	5.7	8.5
At 31 December 2014	229.2	122.3	67.9	419.4

	Exposure value			
	Europe US$bn	Asia US$bn	North America US$bn	Total exposure US$bn
Secured on real estate property				
Expected loss band				
- less than 1%	152.1	85.1	40.4	277.6
- greater than or equal to 1% and less than 5%	1.2	1.1	13.2	15.5
- greater than or equal to 5% and less than 10%	0.3	-	3.5	3.8
- greater than or equal to 10% and less than 20%	0.1	-	2.6	2.7
- greater than or equal to 20% and less than 40%	-	-	1.7	1.7
- greater than or equal to 40% or exposures in default	1.1	0.3	8.0	9.4
	154.8	86.5	69.4	310.7
Qualifying revolving retail exposures				
Expected loss band				
- less than 1%	30.2	21.2	3.5	54.9
- greater than or equal to 1% and less than 5%	5.2	3.3	0.8	9.3
- greater than or equal to 5% and less than 10%	1.0	0.5	0.2	1.7
- greater than or equal to 10% and less than 20%	0.2	0.2	-	0.4
- greater than or equal to 20% and less than 40%	-	0.1	0.1	0.2
- greater than or equal to 40% or exposures in default	0.3	-	0.1	0.4
	36.9	25.3	4.7	66.9
SMEs				
Expected loss band				
- less than 1%	9.0	0.8	0.3	10.1
- greater than or equal to 1% and less than 5%	5.8	-	0.3	6.1
- greater than or equal to 5% and less than 10%	0.7	-	-	0.7
- greater than or equal to 10% and less than 20%	0.3	-	-	0.3
- greater than or equal to 20% and less than 40%	0.1	-	-	0.1
- greater than or equal to 40% or exposures in default	1.3	-	-	1.3
	17.2	0.8	0.6	18.6
Other retail				

Expected loss band				
- less than 1%	33.9	5.1	2.6	41.6
- greater than or equal to 1% and less than 5%	2.9	0.6	0.3	3.8
- greater than or equal to 5% and less than 10%	0.3	0.1	0.1	0.5
- greater than or equal to 10% and less than 20%	0.1	-	0.1	0.2
- greater than or equal to 20% and less than 40%	0.1	-	0.1	0.2
- greater than or equal to 40% or exposures in default	0.5	-	-	0.5
	37.8	5.8	3.2	46.8
Total retail				
Expected loss band				
- less than 1%	225.2	112.2	46.8	384.2
- greater than or equal to 1% and less than 5%	15.1	5.0	14.6	34.7
- greater than or equal to 5% and less than 10%	2.3	0.6	3.8	6.7
- greater than or equal to 10% and less than 20%	0.7	0.2	2.7	3.6
- greater than or equal to 20% and less than 40%	0.2	0.1	1.9	2.2
- greater than or equal to 40% or exposures in default	3.2	0.3	8.1	11.6
At 31 December 2013	246.7	118.4	77.9	443.0

1 The MENA and Latin America regions are not included in this table as retail exposures in these regions are calculated under the standardised approach.

Model performance

Model validation within HSBC is subject to global internal standards. All material models whose outputs are used in calculations of IRB capital requirements fall under this governance framework. These arrangements are designed to support a comprehensive quantitative and qualitative process within a cycle of model monitoring and validation that includes:

· investigation of model stability;

· model performance measured through testing the model's outputs against actual outcomes; and

· model use within the business, e.g. user input data quality, override activity, and the assessment of results from key controls around the usage of the rating system as a whole within the overall credit process.

The purpose of periodic monitoring and validation is therefore:

· to determine that the model continues to produce accurate outputs, suitable for the intended purposes;

· to confirm that the model remains conceptually sound, that the model design is still appropriate and the assumptions made at development remain valid;

· to ensure that the model is used for its intended purpose and for appropriate exposures only (use test); and

· to prompt corrective actions when the model outputs move away from the expected levels.

Models are validated against a series of metrics and triggers approved by the governance committee. The metrics and quantitative checks for periodic validation include a review of the data inputs and overall population stability, and an assessment of the model's discriminatory power or rank order capability, its calibration accuracy, and its performance against available benchmarks. The qualitative checks include and reconfirm all elements assessed at design phase, including the model's conceptual soundness.

The results of periodic in-depth validation must be presented to a model governing committee at least annually. A subset of the key performance metrics is produced and reviewed as part of the ongoing monitoring process.

A large number of models are used within the Group, and data at individual model level is, in most cases, immaterial in the context of the Group overall. We therefore disclose data covering most wholesale models including corporate models on an aggregated basis, and on our individually most material retail models as set out in table 31 above. The tables below show estimated values at the beginning of the relevant observation periods, and subsequent actual experienced values, for key Basel calculation metrics. Values for wholesale models are shown in tables 35 and 36, and for retail models in table 37. The basis of preparation of each table is set out below and in footnotes.

Wholesale credit models

For wholesale portfolios, we disclose the performance of models covering sovereign obligors, banks and corporates. As explained on page 45, we operate global models for the first two of these customer groups. In the case of corporates, we have aggregated data on models covering a customer population ranging from large multinational companies to medium-sized and smaller corporates. The PD analysis for this group includes mainly advanced IRB exposures but also a small element of foundation IRB.

In table 35 below, the data for sovereigns and banks are based on such a small number of defaults that the comparison of estimated with actual results, even where these are available, is not fully reflective of a model's performance. To mitigate this characteristic of low-default portfolios, additional analysis is carried out on these models at annual validation. This analysis shows that they discriminate risk well and are appropriately calibrated. The latter reflects both a prudent modelling approach and the conservatism required by regulations. As noted on page 46, sovereign and institutions exposures are subject to an explicit regulatory floor applied for the calculation of regulatory capital.

Within table 35, for back-testing purposes, a customer's CRR/PD is observed at a point in time and then their default or non-default status in the following one-year period is recorded against that PD grade. The PD presentation in table 35 is expressed for all exposure classes on an obligor basis, as model performance is judged on this basis in validation. The LGD and EAD refer to observations for the defaulted population, being the appropriate focus of an assessment of these models' performance.

Table 35: IRB models - estimated and actual values (wholesale)8

	PD1		LGD2		EAD3	
	Estimated	Actuals	Estimated4	Actuals4	Estimated	Actuals
	%	%	%	%	%	%
2014						
Sovereigns model5	2.27	-	-	-	-	-
Banks model6	3.28	-	-	-	-	-
Corporates models7	1.88	1.16	36.83	16.06	0.47	0.34
2013						
Sovereigns model5	4.14	-	-	-	-	-
Banks model6	3.18	0.20	40.01	-	0.06	0.04
Corporates models7	2.63	1.20	33.09	18.69	0.54	0.48

1 Estimated PD for all models is average PD calculated on the number of obligors covered by the model(s).
2 Average LGD values are EAD-weighted.
3 Expressed as a percentage of total EAD which includes all defaulted and non-defaulted exposures for the relevant population.
4 For sovereigns and banks models, estimated and actuals LGD represents the average LGD for customers that have defaulted in the period. For corporates models, they represent the average LGD for customers that have defaulted and which have been resolved in the period.
5 No defaults have been observed in the Sovereign portfolio since 31 December 2012. In 2014 the estimated PD excludes inactive Sovereign obligors.
6 No defaults were observed in the Banks portfolio in 2014. During 2014 two defaults that occurred prior to 2013 were resolved resulting in an actual LGD of 7.86% against an originally estimated LGD of 55%.
7 Covers the combined populations of the global large corporates model, all regional IRB models for large, medium and small corporates and non-bank financial institutions. In 2014 the estimated and observed PDs has been calculated only for unique obligors.
8 Data represents an annual view, analysed as at 30 September.

Table 36 below expands upon the estimated and actual corporate PD in table 35, as sufficient defaults in this population make analysis at this level meaningful. This analysis is conducted as part of regular validation to ensure that, throughout the entire population, there is a satisfactory degree of conservative performance at all grades. Table 36 is not comparable with table 30c on page 50, mainly because table 36 is a distribution of facility limits, rather than exposure value, and for a back-testing population that does not exactly match the exposure class population of table 28 and table 30c.

Table 36: IRB models - corporate PD models - performance by CRR grade

Corporates1			
Facility2		Defaulted3	Estimated PD4
%	%		%

2014			
CRR 0.16	0.01	0.00	0.01
CRR 1.1	6.32	0.00	0.02
CRR 1.2	6.68	0.00	0.04
CRR 2.1	16.71	0.01	0.07
CRR 2.2	13.07	0.00	0.13
CRR 3.1	10.38	0.06	0.22
CRR 3.2	12.50	0.11	0.37
CRR 3.3	6.62	0.25	0.63
CRR 4.1	10.41	0.28	0.87
CRR 4.2	4.12	0.79	1.20
CRR 4.3	3.49	0.83	1.65
CRR 5.1	2.50	0.53	2.25
CRR 5.2	2.09	0.54	3.05
CRR 5.3	1.47	1.74	4.20
CRR 6.1	0.59	3.02	5.75
CRR 6.2	0.30	1.12	7.85
CRR 7.1	0.29	14.59	10.00
CRR 7.2	0.08	2.78	13.00
CRR 8.1	2.31	1.17	19.00
CRR 8.2	0.04	32.32	36.00
CRR 8.3	0.02	4.85	75.00
Total	100.00		

Corporates1

	Facility2	Defaulted3	Estimated PD4	Actual PD5	Diff. in PD
	%	%	%	%	%
2013					
CRR 0.16	0.00	0.00	0.01	0.00	0.01
CRR 1.1	4.83	0.00	0.02	0.00	0.02
CRR 1.2	7.47	0.00	0.04	0.00	0.04
CRR 2.1	20.85	0.00	0.07	0.00	0.07
CRR 2.2	10.38	0.01	0.13	0.03	0.10
CRR 3.1	10.79	0.07	0.22	0.16	0.06
CRR 3.2	9.49	0.13	0.37	0.22	0.15
CRR 3.3	8.33	0.15	0.63	0.27	0.36
CRR 4.1	6.40	0.35	0.87	0.48	0.39
CRR 4.2	5.84	0.93	1.20	0.80	0.40
CRR 4.3	4.22	0.47	1.65	0.67	0.98
CRR 5.1	4.18	0.72	2.25	0.76	1.49
CRR 5.2	3.07	0.97	3.05	1.03	2.02
CRR 5.3	1.85	2.77	4.20	1.89	2.31
CRR 6.1	0.98	4.37	5.75	3.28	2.47
CRR 6.2	0.46	5.74	7.85	3.77	4.08
CRR 7.1	0.44	12.69	10.00	7.95	2.05
CRR 7.2	0.15	7.84	13.00	8.68	4.32
CRR 8.1	0.15	9.48	19.00	11.44	7.56
CRR 8.2	0.07	14.94	36.00	13.70	22.30
CRR 8.3	0.05	13.12	75.00	13.64	61.36
Total	100.00				

1 Covers the combined populations of the global large corporates model, all regional IRB models for large, medium and small corporates and non-bank financial institutions.

2 Total facility limits for each CRR grade, expressed as a percentage of total limits granted.

3 Defaulted facilities as a percentage of total facility limits at that grade.

4 The estimated PD is before application of the 0.03% regulatory floor.

5 Actual PD is based on the number of defaulted obligors covered by the model(s), without taking into account the size of the facility granted or the exposures to the obligor.

6 The top band of the wholesale CRR master scale is not available to entities in the corporates exposure class, but restricted to the strongest central governments, central banks and institutions.

Retail credit models

In the case of retail portfolios, we do not operate global models due to the different country-level portfolio performance characteristics and loss history. Given the large number of retail IRB models globally, we disclose information on our most material local models.

The actual and estimated values are derived from the model monitoring and calibration processes performed at a local level. Within the discipline of our Global modelling policies, our analytics teams adopt back-testing criteria specific to local conditions in order to assess the accuracy of their models.

Table 37 below contains the estimated and actual values from the back-testing of our material IRB models covering the HSBC Brand portfolios in the UK, the HSBC portfolios under the Area Management Office in Hong Kong, and the residential mortgage portfolios in the US.

The PD, LGD and EAD estimated values here were calculated to compare with the reported actual values and have a different basis of preparation to the estimates reported in tables 32a and 32b.

Within table 37, for back-testing purposes, a customer's PD is observed at a point in time and their default or non-default status in the following one-year period is recorded against that PD grade. The PD presentation here is expressed on an obligor count basis consisting of non-defaulted obligors at the time of observation. The LGD and EAD refer to observations for the defaulted population, being the appropriate focus of an assessment of these models' performance. The LGD values represent the amount of loss as a percentage of EAD and are calculated based on defaulted accounts that got fully resolved or have completed the modelled recovery outcome period as of the reporting date. The EAD values are presented as a percentage of the total EAD which includes all defaulted and non-defaulted exposures for the relevant population. The regulatory PD and LGD floors of 0.03% and 10%, respectively, are applied during final capital calculation and hence not reflected in the below estimates where applicable.

The UK estimated values in table 37 are based on model outputs including required regulatory downturn adjustments. In conducting the back-testing, our UK HSBC residential mortgage LGD model uses a recovery outcome period of 24 months starting at the date of default. The significant proportion of defaulted population, which has not reached a fully resolved outcome as at the reporting date, contributed to the low actual LGD while the estimated LGD increased as a result of the required downturn adjustments. Overall, UK estimates in table 37 remain conservative and higher than calculated actual values.

The Hong Kong estimated PD and LGD values in table 37 include required stressed factors to reflect downturn conditions, especially in the case of the residential mortgage model. The LGD model for our Hong Kong HSBC residential mortgage portfolio uses a recovery outcome period of 24 months starting at the date of default. The estimates for our Hong Kong HSBC residential mortgage LGD remain higher than the calculated actual values but significantly below the 10% regulatory floor. There is minor under-estimation observed in our Hong Kong HSBC credit card EAD model; however this is already being remediated with model redevelopment expected to be completed by the end of 2015.

The US estimates in table 37 include downturn adjustments and model overlays agreed with the PRA. The LGD models for our Consumer Lending and Mortgage Services portfolios use a recovery outcome period of 30 months, and 36 months in the case of HSBC Mortgage Corporation portfolio, reflecting the longer recovery process due to foreclosure moratoria.

The LGD estimates for our Consumer Lending and Mortgage Services portfolios increased in 2014 when the Gen2 models with additional LGD model overlays as required in the PRA approval were implemented. However, actual LGD values are decreasing due to the continuing sale of defaulted assets and improving US economic conditions.

For the HSBC Mortgage Corporation portfolio, we still report the estimates from the existing Gen1 models. The new Gen2 models for this portfolio are under development and will be submitted for the PRA's approval during 2015. In the meantime, we continue to make the agreed quantitative adjustment to the amount of capital we hold against this portfolio to reflect the underperformance of the existing Gen1 models. The quantitative adjustment is performed at the portfolio RWA and EL levels and hence not reflected in table 37.

Table 37 is not comparable with tables 32a and 32b due to different population and methodology used for the purpose of back-testing, as described above.

Table 37: IRB models - estimated and actual values (retail)

	PD		LGD		EAD	
	Estimated	Actuals	Estimated	Actuals	Estimated	Actuals
	%	%	%	%	%	%
2014						
UK						
HSBC residential mortgage	0.50	0.31	15.82	4.68	0.24	0.23
HSBC credit card	1.37	1.07	91.11	86.30	1.83	1.78
HSBC personal loans	2.28	1.57	81.56	80.45	1.52	1.46
Business Banking (Retail SME)	2.83	2.57	73.04	68.17	2.00	1.88
Hong Kong						
HSBC personal residential mortgage	0.72	0.04	1.26	0.35	0.03	0.03
HSBC credit card	0.62	0.32	92.91	88.13	0.55	0.59
HSBC personal instalment loans	2.37	2.04	89.69	87.66	1.77	1.63
US						
	7.31	7.72	77.16	60.29	7.83	7.72

Consumer Lending real estate first lien						
Mortgage Services real estate first lien	9.43	8.12	71.40	60.17	7.51	7.43
HSBC Mortgage Corporation first lien	5.24	2.28	29.63	39.36	1.00	1.00
2013						
UK						
HSBC residential mortgage	0.55	0.38	17.30	6.40	0.32	0.31
HSBC credit card	1.54	1.27	88.10	84.10	1.70	1.67
HSBC personal loans	3.57	2.35	85.40	73.00	2.19	2.11
Business Banking (Retail SME)	2.39	2.61	78.00	70.00	2.03	1.99
Hong Kong						
HSBC personal residential mortgage	0.71	0.03	1.84	0.43	0.03	0.03
HSBC credit card	0.63	0.33	91.41	84.58	0.56	0.59
HSBC personal instalment loans	2.20	1.99	90.07	96.16	1.69	1.55
US						
Consumer Lending real estate first lien	7.74	8.22	67.13	64.93	7.08	6.72
Mortgage Services real estate first lien	10.15	9.68	60.04	62.92	6.12	5.88
HSBC Mortgage Corporation first lien	4.64	4.43	49.85	37.17	2.40	2.40

EL and credit risk adjustments

We analyse credit loss experience in order to assess the performance of our risk measurement and control processes, and to inform our understanding of the implications for risk and capital management of dynamic changes occurring in the risk profile of our exposures.

This analysis includes comparison of the EL calculated in the use of IRB risk rating models, which drives part of the regulatory capital calculation, with other reported measures of credit loss within financial statements prepared under IFRSs. These measures include loan impairment allowances, value adjustments and credit related provisions for off-balance sheet amounts, collectively referred to as credit risk adjustments ('CRA's). The excess of EL over CRAs is treated as a capital deduction in the composition of regulatory capital.

The disclosures below set out:

· commentary on aspects of the relationship between regulatory EL and CRAs recognised in our financial statements; and

· tables of EL and CRA balances and charges during the period by exposure class (within retail IRB, also by sub-class) and by region.

When comparing EL with measures of credit losses under IFRSs, it is necessary to take into account differences in the definition and scope of each. Below are examples of matters that can give rise to material differences in the way economic, business and methodological drivers are reflected quantitatively in the accounting and regulatory measures of loss.

Tables 38 and 39 set out, for IRB credit exposures, the EL, CRA balances and the actual loss experience reflected in the charges for CRAs.

CRA balances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date. Charges for CRAs represent a movement in the CRA balance during the year, reflecting loss events which occurred during the financial year and changes in estimates of losses arising on events which occurred prior to the current year. EL represents the one-year regulatory expected loss accumulated in the book and is calculated at a point in time.

EL and credit risk adjustments
IRB only (US$bn)

To view charts in PDF format please click on the link below

http://www.rns-pdf.londonstockexchange.com/rns/5403F_-2015-2-22.pdf

Examples of differences in definition and scope between EL and CRA balances

· Under IAS 39 our estimates of loss in impairment allowances are required to reflect the current circumstances and specific cash flow expectations of a customer. EL is based on modelled estimates and although the estimates may be individually assigned to specific exposures, the statistical nature of these models means that they are influenced by the behaviour of the overall portfolio;

· EL is based on exposure values that incorporate expected future drawings of committed credit lines, while CRAs are recognised in respect of financial assets recognised on the balance sheet and in respect of committed credit lines where a loss is probable;

· EL is generally based on TTC estimates of PD over a one-year future horizon, determined via statistical analysis of historical default experience. CRAs are recognised for losses that have been incurred at the balance sheet date;

· In the majority of cases, EL is based on economic downturn estimates of LGD, while CRAs are measured using estimated future cash flows as at the balance sheet date;

· EL incorporates LGD, which may discount recoveries at a different rate from the effective interest rate employed in discounted cash flow analysis for CRAs;

· LGDs typically include all costs associated with recovery, whereas the accounting measurement considers only the costs of obtaining and selling collateral;

· The LGD and EAD used for the EL calculation in the Foundation IRB approach is set by regulations and may differ significantly from the accounting assumptions about estimated cash flows used;

· For EL, certain exposures are subject to regulatory minimum thresholds for one or more parameters, whereas credit losses under IFRSs are determined using management's judgement about estimated future cash flows; and

· In the case of EL, to meet regulatory prudential standards, HSBC's model philosophy favours the incorporation of conservative estimation to accommodate uncertainty, for instance where modelling portfolios with limited data. Under IFRSs, uncertainty is considered when forming management's estimates of future cash flows, using balanced and neutral judgement.

Table 38: IRB expected loss and CRAs - by exposure class1

		CRA	
	Expected loss US$bn	Balances US$bn	Charge for the year US$bn
IRB exposure classes			
Central governments and central banks	0.3	-	-

Institutions	0.3	-	-
Corporates	5.2	4.2	1.1
Retail	7.2	3.1	0.2
- secured by mortgages on immovable property SME	-	-	-
- secured by mortgages on immovable property non-SME	5.1	1.9	(0.1)
- qualifying revolving retail	0.7	0.3	0.1
- other SME	0.7	0.4	-
- other non-SME	0.7	0.5	0.2
At 31 December 2014	13.0	7.3	1.3
IRB exposure classes			
Central governments and central banks	0.3	-	-
Institutions	0.3	0.1	-
Corporates	5.8	4.4	1.5
Retail	9.3	5.1	1.2
- secured on real estate property	7.2	3.6	0.8
- qualifying revolving retail	0.7	0.4	0.3
- SMEs	0.9	0.7	-
- other retail	0.5	0.4	0.1
At 31 December 2013	15.7	9.6	2.7
IRB exposure classes			
Central governments and central banks	0.2	-	-
Institutions	0.3	-	-
Corporates	4.3	3.9	1.3
Retail	12.5	7.3	3.5
- secured on real estate property	9.9	5.3	2.4
- qualifying revolving retail	0.8	0.4	0.6
- SMEs	0.7	1.0	-
- other retail	1.1	0.6	0.5
At 31 December 2012	17.3	11.2	4.8

1 Excludes securitisation exposures because EL is not calculated for this exposure class.

Table 39: IRB expected loss and CRAs - by region1

		CRA	
	Expected loss	Balances	Charge for the year
	US$bn	US$bn	US$bn

Europe	4.8	3.5	0.7
Asia	2.2	1.1	0.4
Middle East and North Africa	0.2	0.1	-
North America	5.7	2.6	0.2
Latin America	0.1	-	-
At 31 December 2014	13.0	7.3	1.3
Europe	6.0	4.5	1.4
Asia	1.9	1.0	0.2
Middle East and North Africa	0.4	0.2	-
North America	7.4	3.9	1.1
Latin America	-	-	-
At 31 December 2013	15.7	9.6	2.7

1 Excludes securitisation exposures because EL is not calculated for this exposure class.

Key points

· Excess expected loss decreased in North America, primarily due to the continued run-off of the US CML retail mortgage portfolio and the sale of lower quality loans, partially offset by some new defaults.

· In Europe, excess expected loss increased as result of the application of a LGD floor to UK corporates and the introduction of LGD floors to selected portfolios with a low default history.

Details of the Group's impaired loans and advances, past due but not impaired assets and impairment allowances and charges are set out from page 136 of the Annual Report and Accounts 2014.
Our approach for determining impairment allowances is explained on page 349 of the Annual Report and Accounts 2014, and the Group's definitions for accounting purposes of 'past due' and 'impaired' are set out on pages 136 and 137.
Under the accounting standards currently adopted by HSBC, impairment allowances, value adjusted and credit related provisions for off-balance sheet amounts are treated as specific CRAs.

Risk mitigation

Our approach when granting credit facilities is to do so on the basis of capacity to repay rather than placing primary reliance on credit risk mitigants. Depending on a customer's standing and the type of product, facilities may be provided unsecured. Mitigation of credit risk is nevertheless a key aspect of effective risk management and, in a diversified financial services organisation such as HSBC, takes many forms.

Our general policy is to promote the use of credit risk mitigation, justified by commercial prudence and good practice as well as capital efficiency. Specifically, detailed policies cover the acceptability, structuring and terms of various types of business with regard to the availability of credit risk mitigation, for example in the form of collateral security. These policies, together with the setting of suitable valuation parameters, are subject to regular review to ensure that they are supported by empirical evidence and continue to fulfil their intended purpose.

Collateral

The most common method of mitigating credit risk is to take collateral. In our retail residential and CRE businesses, a mortgage over the property is usually taken to help secure claims. Physical collateral is also taken in various forms of specialised lending and leasing transactions where income from the physical assets that are financed is also the principal source of facility repayment. In the commercial and industrial sectors, charges are created over business assets such as premises, stock and debtors. Loans to private banking clients may be made against a pledge of eligible marketable securities, cash or real estate. Facilities to SMEs are commonly granted against guarantees given by their owners and/or directors. Guarantees from third parties can arise where the Group extends facilities without the benefit of any alternative form of security, e.g. where it issues a bid or performance bond in favour of a non-customer at the request of another bank.

For credit risk mitigants comprising immovable property the key determinant of concentration at Group level is geographic, which, in the majority of cases, is the same as the reported geographic location of the related exposures. Use of immovable property mitigants for risk management purposes is predominantly in Asia and Europe. Further information regarding collateral held over CRE and residential property is provided on pages 147 and 156 respectively of the Annual Report and Accounts 2014.

Financial collateral

In the institutional sector, trading facilities are supported by charges over financial instruments such as cash, debt securities and equities. Financial collateral in the form of marketable securities is used in much of the Group's OTC derivatives activities and in SFTs such as repos, reverse repos, securities lending and borrowing. Netting is used extensively and is a prominent feature of market standard documentation. Further information regarding collateral held for trading exposures can be found on page 73.

In the banking book we provide customers with working capital management products. Some of these products have loans and advances to customers and customer accounts where we have rights of offset and comply with the regulatory requirements for on balance sheet netting. Under on-balance netting the customer accounts are treated as cash collateral and the effects of this collateral are incorporated in our LGD estimates. For risk management purposes the net amounts of such exposures are subject to limits which are monitored and the relevant customer agreements are subject to review and update, as necessary, to ensure the legal right of offset remains appropriate. At 31 December 2014 in the region of US$90bn of customer accounts were treated as cash collateral, mainly in the UK.

Other forms of collateral

Our Global Banking and Markets business utilises credit risk mitigation to manage the credit risk of its portfolios, with the goal of reducing concentrations in individual names, sectors or portfolios. The techniques in use include credit default swap ('CDS') purchases, structured credit notes and securitisation structures. Buying credit protection creates credit exposure against the protection provider, which is monitored as part of the overall credit exposure to them. Where applicable the transaction is entered into directly with a central clearing house counterparty, otherwise our exposure to CDS protection providers is diversified among mainly banking counterparties with strong credit ratings.

Policy and procedures

Policies and procedures govern the protection of our position from the outset of a customer relationship, for instance in requiring standard terms and conditions or specifically agreed documentation permitting the offset of credit balances against debt obligations, and through controls over the integrity, current valuation and, if necessary, realisation of collateral security.

Valuing collateral

Valuation strategies are established to monitor collateral mitigants to ensure that they will continue to provide the anticipated secure secondary repayment source. Where collateral is subject to high volatility, valuation is frequent; where stable, less so. Market trading activities such as collateralised OTC derivatives and SFTs typically carry out daily valuations in support of margining arrangements. In the residential mortgage business, Group policy prescribes re-valuation at intervals of up to three years, or more frequently as the need arises, for example where market conditions are subject to significant change. Residential property collateral values are determined through a combination of professional appraisals, house price indices or statistical analysis.

Local market conditions determine the frequency of valuation for CRE. Re-valuations are sought where, for example, as part of the regular credit assessment of the obligor, material concerns arise in relation to the performance of the collateral. CRE re-valuation also occurs commonly in circumstances where an obligor's credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation. Where such concerns exist the re-valuation method selected will depend upon the loan to value relationship, the direction in which the local CRE market has moved since last valuation, and most importantly the specific characteristics of the underlying commercial real estate which is of concern.

Recognition of risk mitigation under the IRB approach

Within an IRB approach, risk mitigants are considered in two broad categories: first, those which reduce the intrinsic PD of an obligor and therefore operate as determinants of PD; and second, those which affect the estimated recoverability of obligations and require adjustment of LGD or, in certain limited circumstances, EAD.

The first typically include full parental guarantees - where one obligor within a group of companies guarantees another. This is usually factored into the estimate of the latter's PD, as it is assumed that the guarantor's performance materially informs the PD of the guaranteed entity. PD estimates are also subject to supplementary methodologies in respect of a 'sovereign ceiling', constraining the risk ratings assigned to obligors in countries of higher risk, and where only partial parental support exists. In addition, in certain jurisdictions, certain types of third party guarantee are recognised through substitution of the obligor's PD by the guarantor's PD.

In the second category, LGD estimates are affected by a wider range of collateral including cash, charges over real estate property, fixed assets, trade goods, receivables and floating charges such as mortgage debentures. Unfunded mitigants, such as third party guarantees, are also taken into consideration in LGD estimates where there is evidence that they reduce loss expectation.

The main types of provider of guarantees are banks, other financial institutions and corporates, the latter typically in support of subsidiaries of their company group. Across HSBC, the nature of such customers and transactions is very diverse and the creditworthiness of guarantors accordingly spans a wide spectrum. The creditworthiness of providers of unfunded credit risk mitigation is taken into consideration as part of the guarantor's risk profile when, for example, assessing the risk of other exposures such as direct lending to the guarantor. Internal limits for such contingent exposure are approved in the same way as direct exposures.

EAD and LGD values, in the case of individually assessed exposures, are determined by reference to regionally approved internal risk parameters based on the nature of the exposure. For retail portfolios, credit risk mitigation data is incorporated into the internal risk parameters for exposures and feeds into the calculation of the EL band value summarising both customer delinquency and product or facility risk. Credit and credit risk mitigation data form inputs submitted by all Group offices to centralised databases and processing, including performance of calculations to apply the relevant Basel rules and approach. A range of collateral recognition approaches are applied to IRB capital treatments:

· unfunded protection, which includes credit derivatives and guarantees, is reflected through adjustment or determination of PD, or LGD. Under the IRB advanced approach, recognition may be through PD (as a significant factor in grade determination) or LGD, or both;

· eligible financial collateral under the IRB advanced approach is taken into account in LGD models. Under the IRB foundation approach, regulatory LGD values are adjusted. The adjustment to LGD is based on the degree to which the exposure value would
be adjusted notionally if the Financial Collateral Comprehensive Method ('FCCM') were applied; and

· for all other types of collateral, including real estate, the LGD for exposures calculated under the IRB advanced approach will be calculated by models. For IRB foundation, base regulatory LGDs are adjusted depending on the value and type of the asset taken as collateral relative to the exposure. The types of eligible mitigant recognised under the IRB foundation approach are more limited.

The table below sets out, for IRB exposures, the exposure value and the effective value of credit risk mitigation expressed as the exposure value covered by the credit risk mitigant. IRB credit risk mitigation reductions of EAD were immaterial at 31 December 2014.

Table 40: IRB exposure - credit risk mitigation

	At 31 December 2014		At 31 December 2013	
	Exposure value covered by credit derivatives or guarantees1 US$bn	Total exposure value US$bn	Exposure value covered by credit derivatives or guarantees US$bn	Total exposure value US$bn
Exposures under the IRB advanced approach				
Central governments and central banks	0.3	327.4	-	341.7
Institutions	0.8	130.4	2.1	130.0
Corporates	82.3	625.8	55.9	508.7
Retail	21.3	419.4	29.6	443.0
Securitisation positions	-	38.3	-	45.4
Non-credit obligation assets	-	52.5	-	-
		1,593.8		1,468.8
Exposures under the IRB foundation approach				
Central governments and central banks	-	0.1	-	-
Institutions	-	0.1	-	-
Corporates2	0.5	25.6	0.1	23.6

1 Figures presented in an 'obligor view'.
2 The value of exposures under the IRB foundation approach covered by eligible financial and other collateral was US$0.5bn (2013: US$0.6bn).

Application of the standardised approach
The standardised approach is applied where exposures do not qualify for use of an IRB approach and/or where an exemption from IRB has been granted. The standardised approach requires banks to use risk assessments prepared by External Credit Assessment Institutions ('ECAI's) or Export Credit Agencies to determine the risk weightings applied to rated counterparties.

ECAI risk assessments are used within the Group as part of the determination of risk weightings for the following classes of exposure:

- Central governments and central banks;
- Institutions;
- Corporates;
- Securitisation positions;
- Short-term claims on institutions and corporates;
- Regional governments and local authorities; and
- Multilateral development banks.

We have nominated three ECAIs for this purpose - Moody's Investors Service ('Moody's'), S&P and Fitch Group ('Fitch'). We have not nominated any Export Credit Agencies.

Data files of external ratings from the nominated ECAIs are matched with customer records in our centralised credit database.

When calculating the risk-weighted value of an exposure using ECAI risk assessments, risk systems identify the customer in question and look up the available ratings in the central database according to the rating selection rules. The systems then apply the prescribed credit quality step mapping to derive from the rating the relevant risk weight.

All other exposure classes are assigned risk weightings as prescribed in the PRA's rulebook

Credit quality step	Moody's assessments	S&P's assessments	Fitch's assessments
1	Aaa to Aa3	AAA to AA-	AAA to AA-
2	A1 to A3	A+ to A-	A+ to A-
3	Baa1 to Baa3	BBB+ to BBB-	BBB+ to BBB-
4	Ba1 to Ba3	BB+ to BB-	BB+ to BB-
5	B1 to B3	B+ to B-	B+ to B-
6	Caa1 and below	CCC+ and below	CCC+ and below

Exposures to, or guaranteed by, central governments and central banks of EEA States are risk-weighted at 0% using the standardised approach, provided they would be eligible under that approach for a 0% risk weighting.

Associates' exposures are calculated under the standardised approach and, at 31 December 2014, represented approximately 16% (2013: 17%) of Group credit risk RWAs.

Recognition of risk mitigation under the standardised approach

Where credit risk mitigation is available in the form of an eligible guarantee, non-financial collateral, or credit derivatives, the exposure is divided into covered and uncovered portions. The covered portion, which is determined after applying an appropriate 'haircut' for currency and maturity mismatch (and for omission of restructuring clauses for credit derivatives, where appropriate) to the amount of the protection provided, attracts the risk weight of the protection provider. The uncovered portion attracts the risk weight of the obligor. For exposures fully or partially covered by eligible financial collateral, the value of the exposure is adjusted under the FCCM using supervisory volatility adjustments, including those arising from currency mismatch, which are determined by the specific type of collateral (and, in the case of eligible debt securities, their credit quality) and its liquidation period. The adjusted exposure value is subject to the risk weight of the obligor.

Table 41 sets out the credit risk mitigation for exposures under the standardised approach, expressed as the exposure value covered by the credit risk mitigant, and table 42 sets out the distribution of standardised exposures across credit quality steps. This analysis excludes regional governments or local authorities, short-term claims, securitisation positions, collective investment undertakings and multilateral development banks, as these exposures continue to be immaterial as a percentage of total standardised exposures. Also excluded, because the credit quality step methodology does not apply, are retail, equity, exposures in default and exposures secured by mortgages on immovable property.

Table 41: Standardised exposure - credit risk mitigation

	At 31 December 2014			At 31 December 2013		
	Exposure value covered by eligible financial and other collateral1	Exposure value covered by credit derivatives or guarantees1	Total exposure value	Exposure value covered by eligible financial and other collateral	Exposure value covered by credit derivatives or guarantees	Total Exposure value
	US$bn	US$bn	US$bn	US$bn	US$bn	US$bn
Exposures under the standardised approach						
Central governments and central banks	-	-	189.3	-	4.4	220.0
Institutions	-	2.5	30.1	-	3.4	35.2

Corporates	14.8	4.8	240.1	13.1	5.5	221.8
Retail	0.8	0.1	47.9	1.0	-	47.7
Secured by mortgages on immovable property	0.2	-	38.6	-	-	50.4
Exposures in default	-	-	4.7	-	-	4.1
Regional governments or local authorities	-	-	1.1	-	-	0.8
Equity	-	-	13.2	-	-	3.3
Other2	-	-	25.5	0.2	-	84.4
At 31 December			590.5			667.7

1 Figures presented in an 'obligor view'.

2 This includes the exposure class 'other items' with an exposure value of US$17.0bn as well as other less material standardised exposure classes not individually shown above

Table 42: Standardised exposure - by credit quality step

	At 31 December 2014			At 31 December 2013	
	Original exposure1	Exposure value2	RWAs	Exposure value2	RWAs
	US$bn	US$bn	US$bn	US$bn	US$bn
Central governments and central banks					
Credit quality step 1	171.0	177.1		218.8	
Credit quality step 2	0.7	0.8		-	
Credit quality step 3	0.6	0.9		-	
Credit quality step 4	0.5	0.5		-	
Credit quality step 5	-	-		0.1	
Credit quality step unrated	9.9	10.0		1.1	
	182.7	189.3	19.7	220.0	0.7
Institutions					
Credit quality step 1	1.2	0.6		3.5	
Credit quality step 2	2.1	1.1		-	
Credit quality step unrated	28.7	28.4		31.7	
	32.0	30.1	11.2	35.2	12.1
Corporates					
Credit quality step 1	2.3	1.3		4.1	
Credit quality step 2	7.3	4.8		2.2	

Credit quality step 3	2.7	1.6		2.8	
Credit quality step 4	2.7	1.7		0.8	
Credit quality step 5	1.6	1.0		0.7	
Credit quality step 6	3.1	2.3		0.3	
Credit quality step unrated	345.9	227.4		210.9	
	365.6	240.1	224.7	221.8	202.1

1 Figures presented in an 'obligor view.'
2 Exposure value is based on guarantor basis for 2014 in accordance with CRD IV reporting requirements and obligor basis for 2013.

Counterparty credit risk

Counterparty credit risk arises for OTC derivatives and SFTs. It is calculated in both the trading and non-trading books, and is the risk that a counterparty may default before settlement of the transaction. An economic loss occurs if the transaction or portfolio of transactions with the counterparty has a positive economic value at the time of default.

Three approaches are used under Basel III to calculate exposure values for counterparty credit risk: standardised, mark-to-market and IMM. Exposure values calculated under these approaches are used to determine RWAs. Across the Group, we use both the mark-to-market and IMM approaches. Under the IMM approach, EAD is calculated by multiplying the effective expected positive exposure with a multiplier called 'alpha'.

Alpha (set to a default value of 1.4) accounts for several portfolio features that increase EL above that indicated by effective expected positive exposure in the event of default:

· co-variance of exposures;
· correlation between exposures and default;
· level of volatility/correlation that might coincide with a downturn;
· concentration risk; and
· model risk.

The effective expected exposure is derived from simulation, pricing and aggregation internal models approved by regulators. These models cover a range of asset classes including interest rate products, foreign exchange products, credit derivatives and equity derivatives.

The IMM model is subject to on-going model validation including monthly model performance monitoring. We also perform quarterly backtesting of the model's risk measures on a set of hypothetical portfolios as well as the market risk factor predictions. Calibration is performed using a minimum of three years historical data.

Our main IMM site is London where approximately 85% of the trade population falls under the IMM approach.

From a risk management perspective, including daily monitoring of credit limit utilisation, products not covered by IMM are subject to conservative asset class add-on tables calculated outside of the IMM framework.

Limits for counterparty credit risk exposures are assigned within the overall credit process. The measure used for counterparty credit risk management is the 95th percentile of potential future exposure.

The credit risk function assigns a limit against each counterparty to cover derivatives exposure which may arise as a result of a counterparty default. The magnitude of this limit will depend on the overall risk appetite and type of derivatives trading undertaken with the counterparty. Risk is then assessed for each counterparty using models that consider volatility, trade maturity and the counterparty legal documentation.

The models and methodologies used in the calculation of counterparty risk are approved by the Markets MOC. Models are subject to ongoing monitoring and validation. Additionally they are subject to independent review at inception and annually thereafter.

Credit valuation adjustment

As shown in table 12, CRD IV introduced a new regulatory capital charge to cover the risk of mark-to-market losses on expected counterparty risk to derivatives: CVA risk.

Further details about CVA risk may be found on page 259 of the Annual Report and Accounts 2014. For modelling details refer to Note 13, CVA methodology found on page 382 of the Annual Report and Accounts 2014.

Collateral arrangements

It is our policy to revalue all traded transactions and associated collateral positions on a daily basis. An independent Collateral Management function manages the collateral process including pledging and receiving collateral, investigating disputes and non-receipts.

Eligible collateral types are controlled under a policy to ensure price transparency, price stability, liquidity, enforceability, independence, reusability and eligibility for regulatory purposes. A valuation 'haircut' policy reflects the fact that collateral may fall in value between the date the collateral was called and the date of liquidation or enforcement. At least 95% of collateral held as credit risk mitigation under Credit Support Annex ('CSA's) is either cash or liquid government securities.

Credit ratings downgrade

A Credit Rating Downgrade clause in a Master Agreement or a Credit Rating Downgrade Threshold clause in a CSA are designed to trigger a series of events if the credit rating of the affected party falls below a specified level. These events may include the requirement to pay or increase collateral, the termination of transactions by the non-affected party or the assignment of transactions by the affected party.

We control the inclusion of credit ratings downgrade language in a Master Agreement or a CSA by requiring each Group office to obtain the endorsement of the relevant credit authority together with the approval of the Regional Global Markets COO via a Documentation Approval Committee.

Relevant management information is in place to enable us to identify any additional collateral requirements, where the threshold levels for these are affected by a credit ratings downgrade clause within a collateral agreement.

At 31 December 2014, the potential value of the additional collateral (pertaining to ISDA CSA downgrade thresholds only) that we would need to post with counterparties in the event of a one-notch downgrade of our rating was US$0.5bn (2013: US$0.5bn) and for a two-notch downgrade US$1.2bn (2013: US$0.9bn).

Counterparty credit risk exposures

The following tables analyse counterparty credit risk exposures and risk-weighted assets.

Table 43: Counterparty credit risk exposure - credit derivative transactions1

	At 31 December 2014			At 31 December 2013		
	Protection bought US$bn	Protection sold US$bn	Total US$bn	Protection bought US$bn	Protection sold US$bn	Total US$bn
Credit derivative products used for own credit portfolio						
Credit default swaps	1.9	0.1	2.0	2.7	-	2.7
Total notional value	1.9	0.1	2.0	2.7	-	2.7
Credit derivative products used for intermediation2						
Credit default swaps	263.3	262.5	525.8	328.3	322.5	650.8
Total return swaps	7.2	15.2	22.4	8.5	16.3	24.8
Total notional value	270.5	277.7	548.2	336.8	338.8	675.6
Total credit derivative notional value at 31 December	272.4	277.8	550.2	339.5	338.8	678.3

1 This table provides a further breakdown of totals reported on page 396 of the Annual Report and Accounts 2014 on an accounting consolidation basis.

2 This is where we act as intermediary for our clients, enabling them to take a position in the underlying securities but without having to take on the risks ourselves.

Table 44: Counterparty credit risk - net derivative credit exposure1

	2014 US$bn	2013 US$bn
Counterparty credit risk2		
Gross total fair values	595.5	569.6
Accounting offset arrangements	(250.5)	(287.3)
Total gross derivatives	345.0	282.3
Less: netting benefits3	(263.4)	(209.0)
Netted current credit exposure	81.6	73.3

Less: collateral held	(49.9)	(43.3)
Net derivative credit exposure at 31 December	31.7	30.0

1 This table provides a further breakdown of totals reported on page 395 in the Annual Report and Accounts 2014 on an accounting consolidation basis.
2 Excludes add-on for potential future credit exposure.
3 This is the netting benefit available for regulatory capital purposes which is not recognised under accounting rules.

Under IFRSs, netting is only permitted if legal right of set-off exists and the cash flows are intended to be settled on a net basis. Under PRA regulatory rules, however, netting is applied for capital calculations if there is legal certainty and the positions are managed on a net collateralised basis. As a consequence, we recognise greater netting under the PRA rules, reflecting the close-out provisions that would take effect in the event of default of a counterparty rather than just those transactions that are actually settled net in the normal course of business.
Table 45 shows how the total OTC derivative regulatory exposures in table 46 are derived from the gross total fair values reported in table 44.

Table 45: Comparison of derivative accounting balances and counterparty credit risk exposure

At 31 December 2014

	Accounting balances US$bn	Regulatory exposures US$bn
Gross total fair values		
OTC derivatives	578.0	578.0
Spot transactions1	13.7	-
Exchange traded derivatives	3.8	3.8
	595.5	581.8
Initial margin posted to central counterparties2	-	9.9
Accounting offset arrangements		
IFRS basis	(250.5)	-
Mark-to-market method		
Potential future credit exposure	-	157.5
Legal right of offset3	-	(314.3)
IMM method		
Modelling impact4	-	(286.8)
Total derivative exposures at 31 December 2014	345.0	148.1

At 31 December 2013	Accounting balances US$bn	Regulatory exposures US$bn
Gross total fair values		
OTC derivatives	556.0	556.0
Exchange traded derivatives and spot transactions1	13.6	-
	569.6	556.0
Central counterparties2	-	(283.6)
Accounting offset arrangements		
IFRS basis	(287.3)	-
Mark-to-market method		
Potential future credit exposure	-	95.1
Legal right of offset3	-	(157.0)
IMM method		
Modelling impact4	-	(104.7)
Total derivative exposures at 31 December 2013	282.3	105.8

1 Spot transactions attract a zero risk-weight under CRD IV rules.
2 Under CRD IV rules, in addition to derivatives transacted with central counterparties, initial margin posted to central counterparties is included in the regulatory exposures when calculating the RWA. Under Basel II OTC derivative exposures transacted with central counterparties were excluded from the counterparty credit risk calculation.
3 Legal right of offset derivative netting is a component of the US$313.3bn derivatives offset in the 'Maximum Exposure to Credit Risk' table on page 131 of the Annual Report and Accounts 2014.
4 The modelling impact for IMM exposures represents the difference between fair value and the EAD (calculated as 1.4 times the Effective Expected Potential Exposure) resulting from the model; the model incorporates offsets for netting benefits, correlation impacts and collateral as well as simulating the impact of potential market movements.

Table 46: Counterparty credit risk exposure - by exposure class, product and method

	IMM		Mark-to-market method		Total counterparty credit risk	
	Exposure value US$bn	RWAs US$bn	Exposure value US$bn	RWAs US$bn	Exposure value US$bn	RWAs US$bn
By exposure class						
IRB advanced approach	27.1	14.4	107.6	45.3	134.7	59.7
Central governments and central banks	1.5	0.3	7.7	0.8	9.2	1.1
Institutions	9.0	4.4	62.8	21.8	71.8	26.2
Corporates	16.6	9.7	37.1	22.7	53.7	32.4

IRB foundation approach	-	-	5.6	2.3	5.6	2.3
Corporates	-	-	5.6	2.3	5.6	2.3
Standardised approach	3.0	-	8.3	4.4	11.3	4.4
Central governments and central banks	3.0	-	3.7	-	6.7	-
Institutions	-	-	0.3	0.1	0.3	0.1
Corporates	-	-	4.3	4.3	4.3	4.3
CVA advanced	-	3.5	-	-	-	3.5
CVA standardised	-	-	-	18.0	-	18.0
CCP standardised	0.1	-	49.4	2.8	49.5	2.8
	30.2	17.9	170.9	72.8	201.1	90.7
By product						
Derivatives (OTC and ETP)	30.2	14.4	117.9	42.8	148.1	57.2
Securities financing transactions	-	-	44.5	7.7	44.5	7.7
Other1	-	-	8.5	2.6	8.5	2.6
CVA advanced	-	3.5	-	-	-	3.5
CVA standardised	-	-	-	18.0	-	18.0
CCP default funds	-	-	-	1.7	-	1.7
At 31 December 2014	30.2	17.9	170.9	72.8	201.1	90.7
By exposure class						
IRB advanced approach	23.9	8.8	105.7	31.9	129.6	40.7
Central governments and central banks	1.2	0.2	3.0	0.7	4.2	0.9
Institutions	6.7	2.1	58.3	11.4	65.0	13.5
Corporates	16.0	6.5	44.4	19.8	60.4	26.3
IRB foundation approach	-	-	3.1	1.5	3.1	1.5
Corporates	-	-	3.1	1.5	3.1	1.5
Standardised approach	1.4	-	9.3	3.6	10.7	3.6
Central governments and central banks	1.4	-	5.1	-	6.5	-
Institutions	-	-	0.5	0.1	0.5	0.1
Corporates	-	-	3.7	3.5	3.7	3.5
	25.3	8.8	118.1	37.0	143.4	45.8
By product						
OTC derivatives	25.3	8.8	80.5	30.2	105.8	39.0
Securities financing transactions	-	-	29.7	4.7	29.7	4.7

Other1	-	-	7.9	2.1	7.9	2.1
At 31 December 2013	25.3	8.8	118.1	37.0	143.4	45.8

1 Includes free deliveries not deducted from regulatory capital.

Key points

· The year on year RWA increase of US$44.9bn is driven by a US$50.0bn increase upon the implementation of CRD IV rules. Further details of these impacts are shown in table 12. A further increase of US$9.7bn was observed under the IRB approach following the implementation of the LGD floor of 45% used in the calculation of risk weights for institution and corporate counterparties in London and corporate counterparties in the rest of the group.

· Offsetting the increases described above, decreases occurred across the portfolio. A reduction of US$3.2bn was due to the incorporation of residual collateral offsets from the internal model method within the exposures under the mark to market method in London. A US$3.9bn net reduction in RWAs was driven by reduced exposures as Bermudan Swaption positions were onboarded to the internal model method and the internal model was calibrated to market data. The calibration of the internal model along with the utilisation of index hedges also contributed to a reduction in the CVA advanced charge of US$1.0bn. A fall of US$2.8bn in the RWA against central counterparties since the implementation of CRD IV was driven by reductions in the c-factors calculated by the central counterparty and used to convert default fund contributions to capital charges. Remaining movements were driven by reductions in exposures in derivatives and security financing transactions.

Table 47: Counterparty credit risk exposure - by exposure class, product and geographical region

	Exposure value					
	Europe US$bn	Asia US$bn	MENA US$bn	North America US$bn	Latin America US$bn	Total US$bn
By exposure class						
IRB advanced approach	69.2	38.3	0.6	25.1	1.5	134.7
Central governments and central banks	5.8	2.5	-	0.6	0.3	9.2
Institutions	32.7	23.6	0.6	13.7	1.2	71.8
Corporates	30.7	12.2	-	10.8	-	53.7
IRB foundation approach	5.3	-	0.3	-	-	5.6
Corporates	5.3	-	0.3	-	-	5.6
Standardised approach	6.7	0.3	1.7	0.1	2.5	11.3
Central governments and central banks	5.8	-	0.9	-	-	6.7
Institutions	0.1	-	0.2	-	-	0.3
Corporates	0.8	0.3	0.6	0.1	2.5	4.3
CVA advanced1	-	-	-	-	-	-
CVA standardised1	-	-	-	-	-	-
CCP standardised	25.1	5.1	-	19.1	0.2	49.5

	106.3	43.7	2.6	44.3	4.2	201.1
By product						
Derivatives (OTC and ETP)	76.5	34.7	1.7	31.5	3.7	148.1
Securities financing transactions	27.4	2.9	0.9	12.8	0.5	44.5
Other	2.4	6.1	-	-	-	8.5
CVA advanced1	-	-	-	-	-	-
CVA standardised1	-	-	-	-	-	-
CCP default funds2	-	-	-	-	-	-
At 31 December 2014	106.3	43.7	2.6	44.3	4.2	201.1
By exposure class						
IRB advanced approach	68.3	33.6	0.3	25.7	1.7	129.6
Central governments and central banks	2.3	0.8	-	0.7	0.4	4.2
Institutions	29.3	22.7	0.3	11.4	1.3	65.0
Corporates	36.7	10.1	-	13.6	-	60.4
IRB foundation approach	2.9	-	0.2	-	-	3.1
Corporates	2.9	-	0.2	-	-	3.1
Standardised approach	5.8	0.3	2.3	-	2.3	10.7
Central governments and central banks	4.7	-	1.8	-	-	6.5
Institutions	0.4	-	0.1	-	-	0.5
Corporates	0.7	0.3	0.4	-	2.3	3.7
	77.0	33.9	2.8	25.7	4.0	143.4
By product						
OTC derivatives	51.5	27.2	1.0	22.9	3.2	105.8
Securities financing transactions	23.4	0.9	1.8	2.8	0.8	29.7
Other	2.1	5.8	-	-	-	7.9
At 31 December 2013	77.0	33.9	2.8	25.7	4.0	143.4

1 The RWA impact due to the CVA capital charge is calculated based on the exposures under the IRB and standardised approaches. No additional exposures are taken into account.
2 Default fund contributions are cash balances posted to central counterparties by all members. These cash balances are not included in the total reported exposure.

Table 48: Counterparty credit risk - RWAs by exposure class, product and geographical region

	RWAs					
	Europe US$bn	Asia US$bn	MENA US$bn	North America US$bn	Latin America US$bn	Total US$bn
By exposure class						
IRB advanced approach	28.5	16.4	0.2	13.9	0.7	59.7
Central governments and central banks	0.6	0.3	-	0.1	0.1	1.1
Institutions	12.4	7.6	0.2	5.4	0.6	26.2
Corporates	15.5	8.5	-	8.4	-	32.4
IRB foundation approach	2.1	-	0.2	-	-	2.3
Corporates	2.1	-	0.2	-	-	2.3
Standardised approach	0.8	0.3	0.7	-	2.6	4.4
Central governments and central banks	-	-	-	-	-	-
Institutions	-	-	0.1	-	-	0.1
Corporates	0.8	0.3	0.6	-	2.6	4.3
CVA advanced	3.5	-	-	-	-	3.5
CVA standardised	4.4	4.7	0.1	8.1	0.7	18.0
CCP Standardised	1.3	0.5	-	1.0	-	2.8
	40.6	21.9	1.2	23.0	4.0	90.7
By product						
Derivatives (OTC and ETP)	26.1	15.0	1.1	11.9	3.1	57.2
Securities financing transactions	4.5	0.5	-	2.5	0.2	7.7
Other	1.3	1.3	-	-	-	2.6
CVA advanced	3.5	-	-	-	-	3.5
CVA standardised	4.4	4.7	0.1	8.1	0.7	18.0
CCP default funds	0.8	0.4	-	0.5	-	1.7
At 31 December 2014	40.6	21.9	1.2	23.0	4.0	90.7
By exposure class						
IRB advanced approach	20.8	10.6	0.2	8.5	0.6	40.7
Central governments and central banks	0.4	0.2	-	0.2	0.1	0.9
Institutions	6.8	4.0	0.2	2.0	0.5	13.5
Corporates	13.6	6.4	-	6.3	-	26.3
IRB foundation approach	1.4	-	0.1	-	-	1.5
Corporates	1.4	-	0.1	-	-	1.5
Standardised approach	0.8	0.3	0.4	-	2.1	3.6

Central governments and central banks	-	-	-	-	-	-
Institutions	-	-	0.1	-	-	0.1
Corporates	0.8	0.3	0.3	-	2.1	3.5
	23.0	10.9	0.7	8.5	2.7	45.8
By product						
OTC derivatives	18.4	9.9	0.6	7.8	2.3	39.0
Securities financing transactions	3.3	0.2	0.1	0.7	0.4	4.7
Other	1.3	0.8	-	-	-	2.1
At 31 December 2013	23.0	10.9	0.7	8.5	2.7	45.8

Wrong-way risk

Wrong-way risk occurs when a counterparty's exposures are adversely correlated with its credit quality. There are two types of wrong-way risk.

· General wrong-way risk occurs when the probability of counterparty default is positively correlated with general risk factors such as where the counterparty is resident and/or incorporated in a higher-risk country and seeks to sell a non-domestic currency in exchange for its home currency.

· Specific wrong-way risk occurs when the exposure to a particular counterparty is positively correlated with the probability of counterparty default such as a reverse repo on the counterparty's own bonds. HSBC policy sets out that specific wrong-way transactions are approved on a case by case basis.

We use a range of tools to monitor and control wrong-way risk, including requiring the business to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines. The regional Traded Risk functions are responsible for the control and the monitoring process. This includes the monthly submission of wrong-way risk information to the GB&M Risk Management Committee.

Table 49: Counterparty credit risk - RWA density by exposure class, product and geographical region

	RWA density					
				North	Latin	
	Europe	Asia	MENA	America	America	Total
	%	%	%	%	%	%
By exposure class						
IRB advanced approach						
Central governments and central banks	10	14	-	17	38	12
Institutions	38	32	34	39	48	36
Corporates	50	70	-	78	-	60

IRB foundation approach						
Corporates	40	-	57	-	-	41
Standardised approach						
Central governments and central banks	-	-	-	-	-	-
Institutions	-	-	37	-	-	37
Corporates	100	100	97	-	102	99
CVA advanced	-	-	-	-	-	-
CVA standardised	-	-	-	-	-	-
CCP standardised	5	9	-	5	-	6
	38	50	47	52	95	45
By product						
Derivatives (OTC and ETP)	34	43	62	38	82	39
Securities financing transactions	17	18	-	19	40	17
Other	52	22	-	-	-	31
CVA advanced	-	-	-	-	-	-
CVA standardised	-	-	-	-	-	-
CCP default funds	-	-	-	-	-	-
At 31 December 2014	38	50	47	52	95	45
By exposure class						
IRB advanced approach						
Central governments and central banks	20	25	-	23	21	22
Institutions	24	18	41	17	34	21
Corporates	37	63	-	46	-	44
IRB foundation approach						
Corporates	48		54	-	-	48
Standardised approach						
Central governments and central banks	-	-	-	-	-	-
Institutions	-	-	42	-	-	12
Corporates	97	100	98	100	95	96
	30	32	23	33	67	32
By product						
OTC derivatives	36	36	62	34	72	37
Securities financing transactions	14	22	3	26	47	16
Other	61	14	-	-	-	27

At 31 December 2013	30	32	23	33	67	32

Central counterparties

Whilst exchange traded derivatives have been cleared through central counterparties ('CCP's) for many years, recent regulatory initiatives designed to reduce systemic risk in the banking system are directing increasing volumes of OTC derivatives to be cleared through CCPs.

A dedicated CCP credit team has been established to manage the interface with CCPs and undertake in-depth

due diligence of the unique risks associated with these organisations. This is to address an implication of the regulations that the Group's risk will be transferred from being distributed among individual, bilateral counterparties to a significant level of risk concentration on CCPs. We have developed a risk appetite framework to manage risk accordingly, on an individual CCP and global basis.

Securitisation

Group securitisation strategy

HSBC acts as originator, sponsor, liquidity provider and derivative counterparty to its own originated and sponsored securitisations, as well as those of third-party securitisations. Our strategy is to use securitisations to meet our needs for aggregate funding or capital management, to the extent that market, regulatory treatments and other conditions are suitable, and for customer facilitation. We have senior exposures to the securities investment conduits ('SIC's): Mazarin Funding Limited, Barion Funding Limited, Malachite Funding Limited and Solitaire Funding Limited. These are not considered core businesses, and exposures are being repaid as the securities they hold amortise.

Group securitisation roles

Our roles in the securitisation process are as follows:

· Originator: where we originate the assets being securitised, either directly or indirectly;

· Sponsor: where we establish and manage a securitisation programme that purchases exposures from third parties; and

· Investor: where we invest in a securitisation transaction directly or provide derivatives or liquidity facilities to a securitisation.

HSBC as originator

We use SPEs to securitise customer loans and advances and other debt that we have originated, in order to diversify our sources of funding for asset origination and for capital efficiency purposes. In such cases, we transfer the loans and advances to the SPEs for cash, and the SPEs issue debt securities to investors to fund the cash purchases. This activity is conducted in a number of regions and across a number of asset classes. We also act as a derivative counterparty. Credit enhancements to the underlying assets may be used to obtain investment grade ratings on the senior debt issued by the SPEs. The majority of these securitisations are consolidated for accounting purposes (see page 80 for the regulatory treatment). We have also established multi-seller conduit securitisation programmes for the purpose of providing access to flexible market-based sources of finance for our clients to finance discrete pools of third-party originated trade and vehicle finance loan receivables.

In addition, we use SPEs to mitigate the capital absorbed by some of our customer loans and advances we have

originated. Credit derivatives are used to transfer the credit risk associated with such customer loans and advances to an SPE, using securitisations commonly known as synthetic securitisations by which the SPE writes CDS protection to HSBC. These SPEs are consolidated for accounting purposes when the substance of the relationship indicates that we control them.

HSBC as sponsor

We are sponsor to a number of types of securitisation entity, including:

· a multi-seller conduit vehicle established to provide finance to clients - Regency Assets Limited - to which we provide senior liquidity facilities and programme-wide credit enhancement. Assets at the start of 2014 funded via the Bryant Park conduit in the US have now largely been disposed of and Bryant Park is no longer active; and

· four SICs established to provide tailored investments to third-party clients, backed primarily by senior tranches of securitisations and securities issued by financial institutions. Solitaire Funding Limited and Mazarin Funding Limited are asset-backed commercial paper conduits to which we provide transaction-specific liquidity facilities; Barion Funding Limited and Malachite Funding Limited are vehicles to which we provide senior term funding. We also provide a first loss letter of credit to Solitaire Funding Limited. The performance of our exposure to these vehicles is primarily subject to the credit risk of the underlying securities.

Further details of these entities may be found on page 443 of the Annual Report and Accounts 2014.

HSBC as investor

We have exposure to third-party securitisations across a wide range of sectors in the form of investments, liquidity facilities and as a derivative counterparty. These are primarily legacy exposures that are expected to be held to maturity.

These securitisation positions are managed by a dedicated team that uses a combination of market standard systems and third-party data providers to monitor performance data and manage market and credit risks.

In the case of re-securitisation positions, similar processes are conducted in respect of the underlying securitisations.

Valuation of securitisation positions

The valuation process of our investments in securitisation exposures primarily focuses on quotations from third parties, observed trade levels and calibrated valuations from market standard models. This process did not change in 2014.

We perform hedging in respect of our sponsored SICs interest rate and currency exposures. We make limited use of credit default swaps to hedge credit risk in respect of some securitisation positions.

Securitisation accounting treatment

For accounting purposes, we consolidate SPEs when the substance of the relationship indicates that we control them. In assessing control, all relevant factors are considered, including qualitative and quantitative aspects.

Full details of these assessments may be found on page 348 of the Annual Report and Accounts 2014.

We reassess the required consolidation whenever there is a change in the substance of the relationship between HSBC and an SPE, for example, when the nature of our involvement or the governing rules, contractual arrangements or capital structure of the SPE change.

The transfer of assets to an SPE may give rise to the full or partial derecognition of the financial assets concerned. Only in the event that derecognition is achieved are sales and any resultant gains on sales recognised in the financial statements. In a traditional securitisation, assets are sold to an SPE and no gain or loss on sale is recognised at inception.

Full derecognition occurs when we transfer our contractual right to receive cash flows from the financial assets, or retain the right but assume an obligation to pass on the cash flows from the assets, and transfer substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.

Partial derecognition occurs when we sell or otherwise transfer financial assets in such a way that some but not substantially all of the risks and rewards of ownership are transferred but control is retained. These financial assets are recognised on the balance sheet to the extent of our continuing involvement.

A small portion of financial assets that do not qualify for derecognition relate to loans, credit cards, debt securities and trade receivables that have been

securitised under arrangements by which we retain a continuing involvement in such transferred assets. Continuing involvement may entail retaining the rights to future cash flows arising from the assets after investors have received their contractual terms (for example, interest rate strips); providing subordinated interest; liquidity support; continuing to service the underlying asset; or entering into derivative transactions with the securitisation vehicles. As such, we continue to be exposed to risks associated with these transactions.

Where assets have been derecognised in whole or in part, the rights and obligations that we retain from our continuing involvement in securitisations are initially recorded as an allocation of the fair value of the financial asset between the part that is derecognised and the part that continues to be recognised on the date of transfer.

Securitisation regulatory treatment

For regulatory purposes, where significant risk in SPEs has been transferred to third parties, these SPEs are not consolidated but exposure to them, including derivatives or liquidity facilities, is risk-weighted as securitisation positions. Of the US$0.8bn (2013: US$1.6bn) of unrealised losses on AFS asset-backed securities disclosed in the Annual Report and Accounts 2014, nil (2013: US$0.1bn) relates to assets within SPEs that are not consolidated for regulatory purposes.

Analysis of securitisation exposures

HSBC's involvement in securitisation activities continued to reduce in the year, which is reflected in the following:

· no securitisation positions backed by revolving exposures other than trade receivables in Regency Assets Limited;

· no facilities subject to early amortisation provisions;

· no material positions held as synthetic transactions (2013: nil);

· no assets awaiting securitisation; and

· we do not provide financial support for securitised assets.

Realised losses were US$0.2bn (2013: US$0.3bn) on securitisation asset disposals during the year. Total exposure includes off-balance sheet assets of US$21.4bn (2013: US$27.3bn) which relate to liquidity lines to securitisation vehicles.

Further details of securitisation legacy positions may be found on page 161 of the Annual Report and Accounts 2014.

Table 50: Securitisation exposure - by approach

	At 31 December 2014			At 31 December 2013		
	Trading book US$bn	Non-trading book US$bn	Total US$bn	Trading book US$bn	Non-trading book US$bn	Total US$bn
IRB approach	2.9	38.3	41.2	2.6	48.6	51.2
Ratings based	2.9	23.6	26.5	2.6	31.1	33.7
Internal assessment approach1	-	14.7	14.7	-	17.1	17.1
Supervisory method	-	-	-	-	0.4	0.4
Standardised	-	0.4	0.4	-	0.4	0.4
At 31 December	2.9	38.7	41.6	2.6	49.0	51.6

1 Applies to exposures in Regency Assets Limited.

Table 51: Securitisation exposure - movement in the year

	Total at 1 January US$bn	Movement in year: As originator US$bn	As sponsor US$bn	As investor US$bn	Total at 31 December US$bn
Aggregate amount of securitisation exposures					
Residential mortgages1	2.5	-	-	1.7	4.2
Commercial mortgages1	4.8	-	-	(0.6)	4.2
Leasing	-	-	-	0.1	0.1
Loans to corporates or SMEs	0.2	-	-	0.9	1.1
Consumer loans	0.4	-	-	(0.1)	0.3
Trade receivables2	17.7	-	(1.8)	-	15.9
Re-securitisations1	25.6	(0.3)	(8.8)	(0.7)	15.8
Other assets	0.4	-	(0.4)	-	-
2014	51.6	(0.3)	(11.0)	1.3	41.6
Aggregate amount of securitisation exposures					
Residential mortgages1	4.2	-	-	(1.7)	2.5

Commercial mortgages1	3.9	-	(0.3)	1.2	4.8
Leasing	-	-	-	-	-
Loans to corporates or SMEs	0.2	-	-	-	0.2
Consumer loans	0.7	-	-	(0.3)	0.4
Trade receivables2	14.2	-	3.6	(0.1)	17.7
Re-securitisations1	31.6	(0.4)	(3.8)	(1.8)	25.6
Other assets	0.5	-	(0.1)	-	0.4
2013	55.3	(0.4)	(0.6)	(2.7)	51.6

1 Residential and Commercial motgages and re-securitisations principally include exposures to Solitaire Funding Limited, Mazarin Funding Limited, Barion Funding Limited and Malachite Funding Limited and restructured on-balance sheet assets. The pools primarily comprise the senior tranches of retail mortgage backed securities, commercial mortgage backed securities, auto ABS, credit card ABS, student loans, collateralised debt obligations, and also include bank subordinated debt.

2 Trade receivables largely relate to Regency Assets Limited and pools are senior with a maturity less than 10 years.

Table 52: Securitisation exposure - by trading and non-trading book

	At 31 December 2014			At 31 December 2013		
	Trading book US$bn	Non-trading book US$bn	Total US$bn	Trading book US$bn	Non-trading book US$bn	Total US$bn
As originator	-	2.1	2.1	-	2.4	2.4
Re-securitisations	-	2.1	2.1	-	2.4	2.4
As sponsor	-	27.9	27.9	-	39.2	39.2
Commercial mortgages	-	-	-	-	-	-
Loans to corporates or SMEs	-	-	-	-	-	-
Trade receivables	-	15.3	15.3	-	17.1	17.1
Re-securitisations	-	12.6	12.6	-	21.7	21.7
Other assets	-	-	-	-	0.4	0.4
As investor	2.9	8.7	11.6	2.6	7.4	10.0
Residential mortgages	1.7	2.5	4.2	1.1	1.4	2.5
Commercial mortgages	0.8	3.4	4.2	0.9	3.9	4.8
Leasing	-	0.1	0.1	-	-	-
Loans to corporates or SMEs	0.1	1.0	1.1	-	0.2	0.2
Consumer loans	0.1	0.2	0.3	0.1	0.3	0.4
Trade receivables	0.1	0.5	0.6	-	0.6	0.6
Re-securitisations	0.1	1.0	1.1	0.5	1.0	1.5
At 31 December	2.9	38.7	41.6	2.6	49.0	51.6

Table 53: Securitisation - asset values and impairments

	At 31 December 2014		At 31 December 2013	
	Underlying assets1	Securitisation	Underlying assets1	Securitisation

	Total US$bn	Impaired and past due US$bn	exposures impairment US$bn	Total US$bn	Impaired and past due US$bn	exposures impairment US$bn
As originator	2.2	2.1	0.7	4.1	3.4	0.9
Residential mortgages	0.3	-	-	0.4	-	-
Commercial mortgages	-	-	-	-	-	-
Re-securitisations2	1.9	2.1	0.7	3.7	3.4	0.9
As sponsor	28.9	0.3	0.2	37.9	0.3	0.3
Commercial mortgages	2.3	-	-	2.3	-	-
Loans to corporates and SMEs	-	-	-	-	-	-
Trade receivables	12.4	-	-	12.9	-	-
Re-securitisations2	14.2	0.3	0.2	20.7	0.3	0.3
Other assets	-	-	-	2.0	-	-
As investor3			-			-
Residential mortgages			-			-
Commercial mortgages			-			-
Re-securitisations			-			-
			-			
At 31 December			0.9			1.24

1 Securitisation exposures may exceed the underlying asset values when HSBC provides liquidity facilities while also acting as derivative counterparty and a note holder in the SPE.
2 For re-securitisations where HSBC has derived regulatory capital requirements based on the underlying pool of assets, the asset value used for the regulatory capital calculation is used in the disclosure of total underlying assets. For other re-securitisations, the carrying value of the assets per the Annual Report and Accounts 2014 is disclosed.
3 For securitisations where HSBC acts as investor, information on third-party underlying assets is not available.
4 The net effect of a number of insignificant movements, compared with prior year, was immaterial.

Table 54: Securitisation exposure - by risk weighting

	Exposure value1				Capital required			
	Trading book		Non-trading book2		Trading book3		Non-trading book	
	S4 US$bn	R5 US$bn	S4 US$bn	R5 US$bn	S4 US$bn	R5 US$bn	S4 US$bn	R5 US$bn
Long-term category - risk weights								
- less than or equal to 10%	0.9	-	16.7	-	-	-	-	-
- > 10% and ≤ 20%	0.9	0.1	8.0	5.6	-	-	-	-
- > 20% and ≤ 50%	0.2	-	1.1	1.4	-	-	-	0.1
- > 50% and ≤ 100%	0.3	-	1.5	0.7	-	-	-	0.1

- > 100% and ≤ 650%	0.3	-	0.1	1.3	0.2	-	0.1	0.3
- > 650% and < 1250%	-	-	-	-	-	-	-	-
1250%	0.2	-	1.1	1.2	0.2	-	1.1	1.2
At 31 December 2014	2.8	0.1	28.5	10.2	0.4	-	1.2	1.7
Long-term category - risk weights								
- less than or equal to 10%	0.8	-	18.2	-	-	-	0.1	-
- > 10% and ≤ 20%	0.4	-	7.0	0.3	-	-	0.1	-
- > 20% and ≤ 50%	0.4	0.4	1.4	13.6	-	-	-	0.5
- > 50% and ≤ 100%	0.1	-	1.9	0.5	-	-	0.1	-
- > 100% and ≤ 650%	0.3	-	0.3	2.4	0.1	0.1	0.1	0.6
- > 650% and < 1250%	-	0.1	-	0.1	-	-	-	-
Deductions from capital	0.1	-	1.6	1.7	0.1	-	1.6	1.7
At 31 December 2013	2.1	0.5	30.4	18.6	0.2	0.1	2.0	2.8

1 There are no short-term category exposures at 31 December 2014 (2013: nil).

2 Non-trading book figures at 31 December 2014 include US$0.4bn exposures treated under the standardised approach (2013: US$0.4bn).

3 Trading book securitisation capital requirements included under the market risk disclosures were US$0.4bn (2013: US$0.2bn).

4 Securitisation.

5 Re-securitisation. The total re-securitisation exposure value is less than that presented in tables 51 and 52, reflecting a differing treatment of Solitaire Funding Limited. In tables 51 and 52, Solitaire is treated as a re-securitisation, while the figures above are based on the fact that Solitaire is consolidated for regulatory purposes, and present the exposure values as securitisations, allocated to the RWA bands of Solitaire's underlying pool of assets.

Key points

· The exposure movement in the year represents any purchase or sale of securitisation assets, the repayment of capital on amortising or maturing securitisation assets.

· The reductions in capital required reflect vertical slicing and sales of assets from re-securitisation vehicles for US$0.2bn and sales of assets held in North America for US$0.3bn.

· External rating upgrades on re-securitisation vehicles reduced capital required by US$0.3bn.

· The implementation of the AFS offset reduced capital required by US$0.7bn.

· The positions reported in the previous year as deductions are reported as risk weight of 1250% in the current year as required under CRD IV.

Market risk

Overview and objectives

Market risk is the risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.

Exposure to market risk

Exposure to market risk is separated into two portfolios:

·Trading portfolios comprise positions arising from market-making and the warehousing of customer-derived positions.

· Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale and held to maturity, and exposures arising from our insurance operations.

Where appropriate, we apply similar risk management policies and measurement techniques to both trading and non-trading portfolios. Our objective is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with our status as one of the world's largest banking and financial services organisations.

The nature of the hedging and risk mitigation strategies performed across the Group corresponds to the market risk management instruments available within each operating jurisdiction. These strategies range from the use of traditional market instruments, such as interest rate swaps, to more sophisticated hedging strategies to address a combination of risk factors arising at portfolio level.

Overview of market risk in global businesses

The diagram below illustrates the main business areas where trading and non-trading market risks reside and market risk measures to monitor and limit exposures.

To view chart in PDF format please click on the link below:

http://www.rns-pdf.londonstockexchange.com/rns/5403F_-2015-2-22.pdf

1 The interest rate risk on the fixed-rate securities issued by HSBC Holdings is not included in the Group VaR.

Market risk governance

Market risk is managed and controlled through limits approved by the Risk Management Meeting of the GMB for HSBC Holdings and our various global businesses. These limits are allocated across business lines and to the Group's legal entities.

The management of market risk is principally undertaken in Global Markets, where 77% of the total value at risk of HSBC (excluding insurance) and almost all trading VaR resides, using risk limits approved by the GMB. VaR limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set.

Group Risk, an independent unit within Group Head Office, is responsible for our market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis. The market risk limits are governed according to the framework illustrated to the right.

To view chart in PDF format please click on the link below:

http://www.rns-pdf.londonstockexchange.com/rns/5403F_-2015-2-22.pdf

Each operating entity is required to assess the market risks arising on each product in its business and to transfer them to either its local Markets unit for management, or to separate books managed under the supervision of the local ALCO.

Our aim is to ensure that all market risks are consolidated within operations that have the necessary skills, tools, management and governance to manage them. In certain cases where the market risks cannot be fully transferred, we identify the impact of varying scenarios on valuations or on net interest income resulting from any residual risk positions.

Model risk is governed through MOCs at the regional and global wholesale credit and market risk levels. They have direct oversight and approval responsibility for all traded risk models utilised for risk measurement and management and stress testing. The MOCs prioritise the development of models, methodologies and practices used for trading risk management within the Group and ensure that they remain within our risk appetite and business plans. The Markets MOC reports into the Group MOC, which oversees all model risk types at Group level. Group MOC informs the Group RMM about material issues at least on a bi-annual basis. The RMM is the Group's 'Designated Committee' according to the regulatory rules and it has delegated day-to-day governance of all trading risk models to the Markets MOC.

Our control of market risk in the trading and non-trading portfolios is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by Group Risk, of enforcing new product approval procedures, and of restricting trading in the more complex derivative products only to offices with appropriate levels of product expertise and robust control systems.

Table 55: Market risk - RWAs and capital required

	At 31 December 2014		At 31 December 2013	
	Capital required US$bn	RWAs US$bn	Capital required US$bn	RWAs US$bn
Internal model based	3.6	44.6	4.2	52.2
VaR	0.6	7.3	0.4	4.9
Stressed VaR	0.8	10.4	0.8	9.4
Incremental risk charge	1.6	20.1	1.8	23.1
Comprehensive risk measure	-	-	0.2	2.6
Other VaR and stressed VaR1	0.6	6.8	1.0	12.2
PRA standard rules	0.9	11.4	0.9	11.2
Interest rate position risk	0.4	4.8	0.6	7.8
Foreign exchange position risk	0.1	0.7	0.1	1.1
Equity position risk	-	0.3	-	0.2
Commodity position risk	-	0.1	-	0.1
Securitisations	0.4	5.5	0.2	2.0
At 31 December	4.5	56.0	5.1	63.4

1 These are results from countries which cannot be included in the consolidated VaR permission because regulatory permission to do so has not been received, and which must therefore be aggregated rather than consolidated.

Key points

· Other VaR and stressed VaR decreased by US$5.4bn over the period due to PRA permission being granted to consolidate further sites within the global aggregated portfolio and a reduction in the positions within the sites outside of the global aggregated portfolio.

· Incremental risk charge decreased US$2.0bn due to PRA permission being granted to consolidate further sites within the global aggregated portfolio and a further US$1.0bn reduction driven by a re-calibration of matrices within the model.

· Comprehensive risk measure decreased over the period due to the disposal of the US Correlation Trading book.

· VaR and stressed VaR increased by a total of US$3.4bn over the period due to the loss of diversification benefit within the RNIV framework and the treatment of cross currency collateral in VaR, partially offset following a reduction in the positions for the Equities and FX desk and refinements in the RNIV calculations.

· Securitisation increased US$3.5bn over the period largely due to positions previously deducted from capital now being treated as 1250% RWAs under CRD IV.

· Interest Rate position risk decreased over the period primarily in Latin America due to the introduction of the Scenario Matrix Method for options and a general reduction in positions resulting in an RWA reduction of US$1.0bn. A further US$1.7bn reduction occurred in the US.

Market risk measures

Monitoring and limiting market risk exposures
Our objective is to manage and control market risk exposures while maintaining a market profile consistent with our risk appetite.
We use a range of tools to monitor and limit market risk exposures including sensitivity analysis, value at risk and stress testing.

Sensitivity analysis

Sensitivity analysis measures the impact of individual market factor movements on specific instruments or portfolios including interest rates, foreign exchange rates and equity prices, such as the effect of a one basis point change in yield. We use sensitivity measures to monitor the market risk positions within each risk type. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Value at risk

VaR is a technique that estimates the potential losses on risk positions in the trading portfolio as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. The use of VaR is integrated into market risk management and is calculated for all trading positions regardless of how we capitalise those exposures. Where there is not an approved internal model, we use the appropriate local rules to capitalise exposures locally.

In addition, we calculate VaR for non-trading portfolios in order to have a complete picture of risk. Our models are predominantly based on historical simulation. VaR is calculated at a 99% confidence level for a one-day holding period. Where we do not calculate VaR explicitly, we use alternative tools as described summarised in the Market Risk Stress Testing table found in the Stress testing section below.

Our VaR models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

The historical simulation models used incorporate the following features:

· historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;

· potential market movements utilised for VaR are calculated with reference to data from the past two years; and

· VaR measures are calculated to a 99% confidence level and use a one-day holding period.

The nature of the VaR models means that an increase in observed market volatility will lead to an increase in VaR even without any changes in the underlying positions.

VaR model limitations

Although a valuable guide to risk, VaR should always be viewed in the context of its limitations, for example:

· the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;

· the use of a holding period assumes that all positions can be liquidated or the risks offset during that period. This may not fully reflect the market risk arising at times of severe illiquidity, when the holding period may be insufficient to liquidate or hedge all positions fully;

· the use of a 99% confidence level by definition does not take into account losses that might occur beyond this level of confidence;

· VaR is calculated on the basis of exposures outstanding at close of business and therefore does not necessarily reflect intra-day exposures; and

· VaR is unlikely to reflect loss potential on exposures that only arise under conditions of significant market movement.

Risk-not-in-VaR framework

Our VaR model is designed to capture significant basis risk such as credit default swap versus bond, asset swap spreads and cross-currency basis. Other basis risks which are not completely covered in VaR, such as the Libor tenor basis, are complemented by our RNIV calculations and are integrated into our capital framework.

The RNIV framework therefore aims to capture and capitalise material market risks that are not adequately covered in the VaR model. An example of this is Libor-overnight index swap basis risk for minor currencies. In such instances the RNIV framework uses stress tests to quantify the capital requirement. On average in 2014, the capital requirement derived from these stress tests represented 2.6% of the total internal model-based market risk requirement.

Risks covered by RNIV represent 18% of market risk RWAs for models with regulatory approval and include those resulting from underlying risk factors which are not observable on a daily basis across asset classes and products, such as dividend risk and correlation risks.

Risk factors are reviewed on a regular basis and either incorporated directly in the VaR models, where possible, or quantified through the VaR-based RNIV approach or a stress test approach within the RNIV framework. The severity of the scenarios is calibrated to be in line with the capital adequacy requirements. The outcome of the VaR-based RNIV is included in the VaR calculation and back-testing; a stressed VaR RNIV is also computed for the risk factors considered in the VaR-based RNIV approach.

In 2014, we modified our RNIV model on a non-diversified basis across risk factors to comply with new PRA CRDIV implementation guidelines.

Level 3 assets

The fair values of Level 3 assets and liabilities in trading portfolios are disclosed on page 380 of the Annual Report and Accounts 2014, and represent only a small proportion of the overall trading portfolio. Market risk arising from Level 3 instruments is managed by various market risk techniques such as stress testing and notional limits.

Back-testing

We routinely validate the accuracy of our VaR models by back-testing them against both clean and hypothetical profit and loss against the corresponding VaR numbers. Hypothetical profit and loss excludes non-modelled items such as fees, commissions and revenues of intra-day transactions.

We would expect on average to see two or three profits, and two or three losses, in excess of VaR at the 99% confidence level over a one-year period. The actual number of profits or losses in excess of VaR over this period can therefore be used to gauge how well the models are performing. To ensure a conservative approach to calculating our risk exposures, it is important to note that profits in excess of VaR are only considered when back-testing the accuracy of our models and are not used to calculate the VaR numbers used for risk management or capital purposes.

We back-test our Group VaR at various levels which reflect a full legal entity scope of HSBC, including entities that do not have local permission to use VaR for regulatory purposes.

Stress testing

Stress testing is an important tool that is integrated into our market risk management tool to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables. In such abnormal scenarios, losses can be much greater than those predicted by VaR modelling.

Stress testing is implemented at legal entity, regional and overall Group levels. A standard set of scenarios is utilised consistently across all regions within the Group. Scenarios are tailored to capture the relevant events or market movements at each level. The risk appetite around potential stress losses for the Group is set and monitored against referral limits.

Market Risk Stress Testing

Sensitivities	Technical	Hypothetical	Historical	
Impact of a single risk factor, e.g. break of a currency peg	Impact of the largest move in each risk factor without consideration of any underlying market correlation	Impact of potential macroeconomic events, e.g. slowdown in mainland China	Scenarios that incorporate historical observations of market movements, e.g. Black Monday 1987 for equities	Reverse Stress Testing

Market risk reverse stress tests are undertaken on the premise that there is a fixed loss. The stress test process identifies which scenarios lead to this loss. The rationale behind the reverse stress test is to understand scenarios which are beyond normal business settings that could have contagion and systemic implications.

Stressed VaR and stress testing, together with reverse stress testing and the management of gap risk, provide management with insights regarding the 'tail risk' beyond VaR for which HSBC's appetite is limited.

Market Risk Capital Models

From a capital perspective, the model limitations are somewhat mitigated by the addition of Stressed VaR detailed below, which by definition incorporates 10-day scenarios in a period of stress.

The Incremental Risk Charge and Comprehensive Risk Measure detailed below, longer capital and liquidity horizons. Capital add-ons also exist to capture event risk including foreign exchange risk on pegged currencies and concentration risk associated with large equity holdings.

Table 56: Market risk models1

Model component	RWAs for associated asset class US$bn	Confidence level	Horizon	Model description and methodology
VaR	7.3	99%	10 day	Uses most recent two years' worth of daily returns to determine a loss distribution. The result is scaled from one day to provide an equivalent 10-day loss.
Stressed VaR	10.4	99%	10 day	Stressed VaR is calibrated to a one-year period of stress observed in history.
IRC	20.1	99.9%	1 year	Uses a multi-factor Gaussian Monte-Carlo simulation which includes product basis, concentration, hedge mismatch, recovery rate and liquidity as part of the simulation process. A minimum liquidity horizon of three months is applied and is based on a combination of factors including issuer type, currency and size of exposure.
CRM	-	99.9%	1 year	Calibrated to the same soundness standard as the IRC above, and the risk factors covered include credit migration, default, credit spread, correlation, recovery rate and basis risks. Following the sale of the correlation portfolio we no longer calculate a capital requirement for CRM.

1 Non-proprietary details are available in the Financial Services Register on the PRA website.

Stressed VaR

Stressed VaR is primarily used for regulatory capital purposes and is integrated into the risk management process to ensure prudent capital management. Stressed VaR complements other risk measures by providing the potential losses arising from market turmoil. Calculations are based on a continuous one-year period of stress for the trading portfolio, based on the assessment at the Group level.

Stress VaR modelling follows the same approach as our VaR risk measure except for the following:

· potential market movements employed for stressed VaR calculations are based on a continuous one-year period of stress for the trading portfolio;

· the choice of period (November 2007 to November 2008) is based on the assessment at the Group level of the most volatile period in recent history; and

· it is calculated to a 99% confidence using a 10-day holding period.

Information on our VaR risk measure is included on pages 177 and 178 of the Annual Report and Accounts 2014.

Stressed value at risk (one-day equivalent)

	2014 US$m
At 31 December	83.3
Maximum	108.1
Minimum	21.7
Average	65.4

Stressed VaR exposures contribute to the capital held by HSBC against market risk factors. Stressed VaR fluctuated through 2014, reflecting the changing positions held by HSBC. Additionally stressed VaR increased due to modelling changes that removed certain diversification benefits.

Incremental Risk Charge

The IRC measures the default and migration risk of issuers of traded instruments.

Risk factors covered by it include credit migration, default, product basis, concentration, hedge mismatch, recovery rate and liquidity. The PDs are floored to reflect the lack of historical data on defaults and a period of stress is used to calibrate the spread changes for the relevant ratings. The IRC model is validated quarterly by stressing key model parameters and reviewing the response of the model.

The IRC is a standalone charge generating no diversification benefit with other charges.

The IRC model was updated to account for the dependency of the recovery rate and the economic cycle. Additionally, further granularity in parameters was introduced, in order to better represent the risk profile. As part of normal model oversight the IRC model is periodically recalibrated in order to continue accurately to capture the risk profile in a stressed environment.

Incremental risk charge

	2014 US$m
At 31 December	1,781
Maximum	2,980
Minimum	1,754
Average	2,308

Comprehensive Risk Measure

The CRM is used to measure all price risks emanating from the correlation trading portfolio within a bank and also reflects the associated impact of liquidity, concentration and hedging. This measure is subject to a minimum capital requirement of 8% of RWA calculated under the standard rules for the portfolio. CRM is a standalone charge generating no diversification benefit with other charges.

Following the sale of our correlation portfolio in 2014 we no longer calculate a capital requirement for this measure.

Trading portfolios

Gap risk

Certain products are structured in such a way that they give rise to enhanced gap risk, being the risk that loss is incurred upon occurrence of a gap event. A gap event is a significant and sudden change in market price with no accompanying trading opportunity. Such movements may occur, for example, when, in reaction to an adverse event or unexpected news announcement, some parts of the market move far beyond their normal volatility range and become temporarily illiquid. In 2014 gap risk principally arose from non-recourse loan transactions, mostly for corporate clients, where the collateral against the loan is limited to the posted shares. Upon occurrence of a gap event, the value of the equity collateral could fall below the outstanding loan amount. Given their characteristics, these transactions make little or no contribution to VaR nor to traditional market risk sensitivity measures. We capture their risks within our stress testing scenarios and monitor gap risk on an ongoing basis. We did not incur any notable gap loss in 2014.

De-peg risk

For certain currencies (pegged or managed) the spot exchange rate is pegged at a fixed rate (typically to US dollars or euros), or managed within a pre-defined band around a pegged rate. De-peg risk is the risk of the peg or managed band changing or being abolished, and moving to a floating regime.

HSBC has a lot of experience in managing fixed and managed currency regimes. Using stressed scenarios on spot rates, we are able to analyse how de-peg events would impact the positions held by HSBC. We monitor such scenarios to pegged or managed currencies, such as the Hong Kong dollar, renminbi, Middle Eastern currencies and the Swiss franc with appreciation capped against the euro during 2014, and limit any potential losses that would occur. This complements traditional market risk metrics, such as historical VaR, which may not fully capture the risk involved in holding positions in pegged or managed currencies. Historical VaR relies on past events to determine the likelihood of potential profits or losses. However, pegged or managed currencies may not have experienced a de-peg event during the historical timeframe being considered.

ABS/MBS exposures

The ABS/MBS exposures within the trading portfolios are managed within sensitivity and VaR limits as described on page 176 of the Annual Report and Accounts, and are included within the stress testing scenarios described above.

Non-trading portfolios

Most of the Group's non-trading VaR relates to Balance Sheet Management ('BSM') or local treasury management functions. Contributions to Group non-trading VaR are driven by interest rates and credit spread risks arising from all global businesses. There is no commodity market risk in the non-trading portfolios.

Non-trading VaR also includes the interest rate risk of non-trading financial instruments held by the global businesses and transferred into portfolios managed by BSM or local treasury functions. In measuring, monitoring and managing risk in our non-trading portfolios, VaR is just one of the tools used. The management of interest rate risk in the banking book is described further in 'Non-trading interest rate risk' below, including the role of BSM.

Non-trading VaR excludes equity risk on available-for-sale securities, structural foreign exchange risk, and interest rate risk on fixed rate securities issued by HSBC Holdings, the scope and management of which are described in the relevant sections below.

Our control of market risk in the non-trading portfolios is based on transferring the assessed market risk of non-trading assets and liabilities created outside BSM or Markets, to the books managed by BSM, provided the market risk can be neutralised. The net exposure is typically managed by BSM through the use of fixed rate government bonds (liquid assets held in available-for-sale books) and interest rate swaps. The interest rate risk arising from fixed rate government bonds held within available-for-sale portfolios is reflected within the Group's non-traded VaR. Interest rate swaps used by BSM are typically classified as either a fair value hedge or a cash flow hedge and are included within the Group's non-traded VaR. Any market risk that cannot be neutralised in the market is managed by local ALCO in segregated ALCO books.

Credit spread risk for available-for-sale debt instruments

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VaR. The VaR shows the effect on income from a one-day movement in credit spreads over a two-year period, calculated to a 99% confidence interval.

Available-for-sale equity securities

Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio. Regular reviews are performed to substantiate the valuation of the investments within the portfolio and investments held to facilitate ongoing business, such as holdings in government-sponsored enterprises and local stock exchanges.
Refer to Other risks - Non-trading book exposures in equities on page 93 for additional information.

Structural foreign exchange exposures

Structural foreign exchange exposures represent net investments in subsidiaries, branches and associates, the functional currencies of which are currencies other than the US dollar. An entity's functional currency is that of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recognised in 'Other comprehensive income'. We use the US dollar as our presentation currency in our consolidated financial statements because the US dollar and currencies linked to it form the major currency bloc in which we transact and fund our business. Our consolidated balance sheet is, therefore, affected by exchange differences between the US dollar and all the non-US dollar functional currencies of underlying subsidiaries.

We hedge structural foreign exchange exposures only in limited circumstances. Our structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that our consolidated capital ratios and the capital ratios of individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to RWAs denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

We may also transact hedges where a currency in which we have structural exposures is considered likely to revalue adversely, and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved. We evaluate residual structural foreign exchange exposures using an expected shortfall method.

Details of our structural foreign exchange exposures are provided in Note 33 to the Financial Statements, on page 435 of the Annual Report and Accounts 2014.

Non-trading interest rate risk

Non-trading book interest rate risk arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts, and the re-pricing behaviour of managed rate products. These assumptions around behavioural features are captured in our interest rate risk behaviouralisation framework, which is described below.

We aim, through our management of market risk in non-trading portfolios, to mitigate the effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of such hedging activities on the current net revenue stream.

Our funds transfer pricing policies give rise to a two stage funds transfer pricing approach. For details see page 219 of the Annual Report and Accounts 2014.

The economic capital requirement for non-trading interest rate risk under Pillar 2 is measured by or Economic Value of Equity ('EVE') sensitivity. EVE sensitivity considers all re-pricing mismatches assuming a run-off of the current balance sheet, and quantifies the larger loss in economic value of the Group's net asset position (including off balance sheet positions) under a +/-200bps shock to interest rates.

Asset, Liability and Capital Management ('ALCM') is responsible for measuring and controlling non-trading interest rate risk under the supervision of the RMM. Its primary responsibilities are:

· to define the rules governing the transfer of interest rate risk from the commercial bank to BSM;

· to ensure that all market interest rate risk that can be hedged is effectively transferred from the global businesses to BSM; and

· to define the rules and metrics for monitoring the residual interest rate risk in the global businesses.

The different types of non-trading interest rate risk and the controls which the Group uses to quantify and limit its exposure to these risks can be categorised as follows:

· risk which is transferred to BSM and managed by BSM within a defined risk mandate;

· risk which remains outside BSM because it cannot be hedged or which arises due to our behaviouralised transfer pricing assumptions. This risk will be

captured by our net interest income EVE sensitivity, and corresponding limits are part of our global and regional risk appetite statements for non-trading interest rate risk. A typical example would be margin compression created by unusually low rates in key currencies;

· basis risk which is transferred to BSM when it can be hedged. Any residual basis risk remaining in the global businesses is reported to ALCO. A typical example would be a managed rate savings product transfer-priced using a Libor-based interest rate curve; and

· model risks which cannot be captured by net interest income or EVE sensitivity but are controlled by our stress testing framework. A typical example would be prepayment risk on residential mortgages or pipeline risk.

Details of the Group's monitoring of the sensitivity of projected net interest income under varying interest rate scenarios may be found on page 181 of the Annual Report and Accounts 2014.

Interest rate risk behaviouralisation

Unlike liquidity risk which is assessed on the basis of a very severe stress scenario, non-trading interest rate risk is assessed and managed according to 'business-as-usual' conditions. In many cases the contractual profile of non-trading assets/liabilities arising from assets/liabilities created outside Markets or BSM does not reflect the behaviour observed. Behaviouralisation is therefore used to assess the market interest rate risk of non-trading assets/liabilities and this assessed market risk is transferred to BSM, in accordance with the rules governing the transfer of interest rate risk from the global businesses to BSM.

Behaviouralisation is applied in three key areas:

· the assessed re-pricing frequency of managed rate balances;

· the assessed duration of non-interest bearing balances, typically capital and current accounts; and

· the base case expected prepayment behaviour or pipeline take-up rate for fixed rate balances with embedded optionality.

Interest rate behaviouralisation policies have to be formulated in line with the Group's behaviouralisation policies and approved at least annually by local ALCO and regional ALCM, in conjunction with local, regional and Group market risk monitoring teams.

The extent to which balances can be behaviouralised is driven by:

· the amount of the current balance that can be assessed as 'stable' under business-as-usual conditions; and

· for managed rate balances the historic market interest rate re-pricing behaviour observed; or

· for non-interest bearing balances the duration for which the balance is expected to remain under business-as-usual conditions. This assessment is often

driven by the re-investment tenors available to BSM to neutralise the risk through the use of fixed rate government bonds or interest rate derivatives, and for derivatives the availability of cash flow hedging capacity.

Balance Sheet Management

Effective governance across BSM is supported by the dual reporting lines it has to the CEO of GB&M and to the Group Treasurer. In each operating entity, BSM is responsible for managing liquidity and funding under the supervision of the local ALCO (which usually meets on a monthly basis). It also manages the non-trading interest rate positions transferred to it within a Global Markets limit structure.

In executing the management of the liquidity risk on behalf of ALCO, and managing the non-trading interest rate positions transferred to it, BSM invests in highly-rated liquid assets in line with the Group's liquid asset policy. The majority of the liquidity is invested in central bank deposits and government, supranational and agency securities with most of the remainder held in short-term interbank and central bank loans.

Withdrawable central bank deposits are accounted for as cash balances. Interbank loans, statutory central bank reserves and loans to central banks are accounted for as loans and advances to banks. BSM's holdings of securities are accounted for as available-for-sale or, to a lesser extent, held-to-maturity assets.

Statutory central bank reserves are not recognised as liquid assets. The statutory reserves that would be released in line with the Group's stressed customer deposit outflow assumptions are reflected as stressed inflows.

BSM is permitted to use derivatives as part of its mandate to manage interest rate risk. Derivative activity is predominantly through the use of vanilla interest rate swaps which are part of cash flow hedging and fair value hedging relationships.

Credit risk in BSM is predominantly limited to short-term bank exposure created by interbank lending, exposure to central banks and high quality sovereigns, supranationals or agencies which constitute the majority of BSM's liquidity portfolio. BSM does not manage the structural credit risk of any Group entity balance sheets.

BSM is permitted to enter into single name and index credit derivatives activity, but it does so to manage credit risk on the exposure specific to its securities portfolio in limited circumstances only. The risk limits are extremely limited and closely monitored. At 31 December 2014 and 31 December 2013 BSM had no open credit derivative index risk.

VaR is calculated on both trading and non-trading positions held in BSM. It is calculated by applying the same methodology used for the Markets business and utilised as a tool for market risk control purposes.

BSM holds trading portfolio instruments in only very limited circumstances. Positions and the associated VaR were not significant during 2014 and 2013.

Sensitivity of net interest income

A principal part of our management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). This monitoring is undertaken at an entity level by local ALCOs.

Entities apply a combination of scenarios and assumptions relevant to their local businesses, and standard scenarios which are required throughout HSBC. The latter are consolidated to illustrate the combined pro forma effect on our consolidated net interest income.

Projected net interest income sensitivity figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Group's current interest rate risk profile. This effect, however, does not incorporate actions which would probably be taken by BSM or in the business units to mitigate the effect of interest rate risk. In reality, BSM seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The net interest income sensitivity calculations assume that interest rates of all maturities move by the same amount in the 'up-shock' scenario. Rates are not assumed to become negative in the 'down-shock' scenario which may, in certain currencies, effectively result in non-parallel shock. In addition, the net interest income sensitivity calculations take account of the effect on net interest income of anticipated differences in changes between interbank interest rates and interest rates over which the entity has discretion in terms of the timing and extent of rate changes.

Defined benefit pension schemes

Market risk arises within our defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. Pension scheme assets include equities and debt securities, the cash flows of which change as equity prices and interest rates (and credit risk) vary. There is a risk that market movements in equity prices and interest rates could result in asset values which, taken together with regular ongoing contributions, are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, and in certain instances trustees (who act on behalf of the pension schemes' beneficiaries), assess these risks using reports prepared by independent external consultants, take action and, where appropriate, adjust investment strategies and contribution levels accordingly.

Refer to Other risks - Pension Risk on page 92 for additional information.

Operational risk

Overview and objectives

Operational risk is defined as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk'.

The current Basel requirements include a capital requirement for operational risk, utilising three levels of sophistication as stated on page 18. We have historically adopted, and currently use, the standardised approach in determining our operational risk capital requirements. We are in the process of developing and implementing an AMA compliant model which we will use for economic capital calculation purposes, and it is our medium-term aim to move to the AMA for our operational risk regulatory capital requirement calculation. The table below sets out an analysis of our operational risk capital requirement by region and global business.

Operational risk is relevant to every aspect of our business, and covers a wide spectrum of issues, in particular legal, compliance, security and fraud. Losses arising from breaches of regulation and law, unauthorised activities, error, omission, inefficiency, fraud, systems failure or external events all fall within the definition of operational risk.

We have historically experienced operational risk losses in the following major categories:

· possible mis-selling of products;

· breach of regulatory requirements;

· fraudulent and other external criminal activities;

· breakdowns in processes/procedures due to human error, misjudgement or malice;

· terrorist attacks;

· system failure or non-availability; and

· in certain parts of the world, vulnerability to natural disasters.

Table 57: Operational risk RWAs

	At 31 December 2014	At 31 December 2013

	Capital required US$bn	RWAs US$bn	Capital required US$bn	RWAs US$bn
By geographical region				
Europe	2.8	35.5	2.8	35.1
Asia	3.7	45.8	3.5	44.1
Middle East and North Africa	0.5	6.2	0.5	6.0
North America	1.2	15.2	1.4	17.2
Latin America	1.2	15.1	1.3	16.8
At 31 December	9.4	117.8	9.5	119.2
By global business				
Retail Banking and Wealth Management	2.9	36.7	3.1	38.8
Commercial Banking	2.6	33.2	2.6	32.9
Global Banking and Markets	3.6	44.5	3.5	43.3
Global Private Banking	0.3	3.6	0.3	3.9
Other	-	(0.2)	-	0.3
At 31 December	9.4	117.8	9.5	119.2

During 2014, our operational risk profile continued to be dominated by compliance and legal risks as referred to in the 'Top and emerging risks' section and Note 40 on the Financial Statements on pages 22 and 446, respectively, of the Annual Report and Accounts 2014. A number of material losses were realised in 2014, which related largely to events that occurred in previous years. These events included the possible historical mis-selling of payment protection insurance ('PPI') products in the UK (see Note 29 on page 420 of the Annual Report and Accounts 2014). A number of mitigating actions continue to be taken to prevent future mis-selling incidents.

The regulatory environment in which we operate is increasing the cost of doing business and could reduce our future profitability. The implementation of Global Standards remains one of the key strategic priorities for the Group and is ongoing.

For further details on Compliance Risk, refer to page 189 of the Annual Report and Accounts 2014.

We recognise that operational risk losses can be incurred for a wide variety of reasons, including rare but extreme events.

The objective of our operational risk management is to manage and control operational risk in a cost-effective manner and within our risk appetite, as defined by GMB.

Organisation and responsibilities

Responsibility for minimising operational risk management lies primarily with HSBC's management and staff. Each regional, global business, country, business unit and functional head is required to maintain oversight over operational risk and internal control, covering all businesses and operational activities for which they are responsible.

The Group Operational Risk function and the Operational Risk Management Framework ('ORMF') assist business management in discharging their responsibilities.

The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control across the Group. To implement the ORMF a 'Three lines of defence' model is used for the management of risk. The first line of defence is every employee at HSBC, the second consists of the Global Functions and the third is Internal Audit.

More details on the 'Three lines of defence' model and our ORMF may be found on page 186 of the Annual Report and Accounts 2014.

The Global Operational Risk Committee, which reports to RMM, meets at least quarterly to discuss key risk issues and review the effective implementation of the ORMF.

Operational risk is organised as a specific risk discipline within Global Risk. The Group Operational Risk function reports to the GCRO and supports the Global Operational Risk Committee. It is responsible for establishing and maintaining the ORMF, monitoring the level of operational losses and the effectiveness of the control environment. It is also responsible for operational risk reporting at Group level, including preparation of reports for consideration by RMM and GRC.

Measurement and monitoring

We have codified our ORMF in a high level standard, supplemented by detailed policies. These policies explain our approach to identifying, assessing, monitoring and controlling operational risk and give guidance on mitigating actions to be taken when weaknesses are identified.

In 2014, we continued to enhance our ORMF policies and procedures, and undertook various activities, such as a global training programme, to further embed the use of the framework in the management of the business.

Articulation of risk appetite for material operational risks helps the business to understand the level of risk our organisation is willing to take. Monitoring operational risk exposure against risk appetite on a regular basis, and setting out our risk acceptance process, drives risk awareness in a more forward-looking manner. It assists management in determining whether further action is required.

In addition, an enhanced Risk Scenario Analysis process has been implemented across material legal entities to improve the quantification and management of material risks. This provides a top down, forward-looking view of risks to help determine whether they are being effectively managed within our risk appetite or whether further management action is required.

In each of our subsidiaries, business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

Operational risk and control assessment approach

Operational risk and control assessments are performed by individual business units and functions. The risk and control assessment process is designed to provide business areas and functions with a forward-looking view of operational risks, an assessment of the effectiveness of controls, and a tracking mechanism for action plans so that they can proactively manage operational risks within acceptable levels. Risk and control assessments are reviewed and updated at least annually.

Appropriate means of mitigation and controls are considered. These include:

- making specific changes to strengthen the internal control environment; and
- investigating whether cost-effective insurance cover is available to mitigate the risk.

Recording

We use a centralised database to record the results of our operational risk management process. Operational risk and control assessments, as described above, are input and maintained by business units. Business management and Business Risk and Control Managers monitor and follow up the progress of documented action plans.

Operational risk loss reporting

To ensure that operational risk losses are consistently reported and monitored at Group level, all Group companies are required to report individual losses when the net loss is expected to exceed US$10,000 and to aggregate all other operational risk losses under US$10,000. Losses are entered into the Operational Risk IT system and are reported to the Group Operational Risk function on a quarterly basis.

Other risks

Pension risk

We operate a number of pension plans throughout the world. Some of them are defined benefit plans. Sponsoring Group companies (and in some instances, employees) make regular contributions in accordance with advice from actuaries and in consultation with the plans' trustees (where relevant). In situations where a funding deficit emerges, sponsoring Group companies agree to make additional contributions to the plans, to address the deficit over an appropriate repayment period.

The defined benefit plans invest these contributions in a range of investments designed to meet their long-term liabilities.

Pension risk principally arises from the potential for a deficit in a defined benefit plan to arise from a number of factors, including:

· investments delivering a return below that required to provide the projected plan benefits. This could arise, for example, when there is a fall in the market value of equities, or when increases in long-term interest rates cause a fall in the value of fixed income securities held;

· the prevailing economic environment leading to corporate failures, thus triggering write-downs in asset values (both equity and debt);

· a change in either interest rates or inflation expectations, causing an increase in the value of the plan liabilities; and

· plan members living longer than expected (known as longevity risk).

Pension risk is assessed by way of an economic capital model that takes into account potential variations in these factors, using VaR methodology.

Non-trading book exposures in equities

Our non-trading equities exposures are reviewed by RMM at least annually. At 31 December 2014, on a regulatory consolidation basis, we had equity investments in the non-trading book of US$10.9bn (2013: US$9.3bn). These consist of investments held for the purposes shown in table 58.

Table 58: Non-trading book equity investments

	At 31 December 2014			At 31 December 2013		
	Available-for-sale US$bn	Designated at fair value US$bn	Total US$bn	Available-for-sale US$bn	Designated at fair value US$bn	Total US$bn
Strategic investments	7.5	0.1	7.6	5.2	0.1	5.3
Private equity investments	2.0	0.1	2.1	2.7	0.1	2.8
Business facilitation1	1.2	-	1.2	1.2	-	1.2
	10.7	0.2	10.9	9.1	0.2	9.3

1 Includes holdings in government-sponsored enterprises and local stock exchanges.

We make investments in private equity primarily through managed funds that are subject to limits on the amount of investment. We risk assess these commitments to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio as a whole, and perform regular reviews to substantiate the valuation of the investments within the portfolio.

Exchange traded investments amounted to US$5.9bn (2013: US$4.0bn), with the remainder being unlisted. These investments are held at fair value in line with market prices and are mainly strategic in nature. The increase in strategic investments was largely due to the increase in the market value of the investment in Industrial Bank. This offset the decrease in private equity holdings from the disposal of various direct and private equity fund investments.

On a regulatory consolidation basis, the net gain from disposal of equity securities amounted to US$1.0bn (2013: US$0.5bn), while impairment of AFS equities amounted to US$0.4bn (2013: US$0.2bn). In 2014, unrealised gains on AFS equities were excluded from regulatory capital, because under the PRA's implementation of CRD IV they can only be recognised in CET1 capital from 1 January 2015, whereas in 2013 under the Basel 2.5 rules unrealised gains on equities of US$1.6bn were included in tier 2 capital.

Details of our accounting policy for AFS equity investments and the valuation of financial instruments may be found on pages 399 and 378, respectively, of the Annual Report and Accounts 2014. A detailed description of the valuation techniques applied to private equity may be found on page 383 of the Annual Report and Accounts 2014.

Risk management of insurance operations

We operate an integrated bancassurance model which provides insurance products principally for customers with whom we have a banking relationship. Insurance products are sold through all global businesses, but predominantly by RBWM and CMB through our branches and direct channels worldwide.

The insurance contracts we sell relate to the underlying needs of our banking customers, which we can identify from our point-of-sale contacts and customer knowledge. The majority of sales are of savings and investment products and term and credit life contracts. By focusing largely on personal and SME lines of business we are able to optimise volumes and diversify individual insurance risks.

Where we have operational scale and risk appetite, mostly in life insurance, these insurance products are manufactured by HSBC subsidiaries. Manufacturing insurance allows us to retain the risks and rewards associated with writing insurance contracts by keeping part of the underwriting profit, investment income and distribution commission within the Group.

Where we do not have the risk appetite or operational scale to be an effective insurance manufacturer, we engage with a handful of leading external insurance companies in order to provide insurance products to our customers through our banking network and direct channels. These arrangements are generally structured with our exclusive strategic partners and earn the Group a combination of commissions, fees and a share of profits.

We distribute insurance products in all of our geographical regions. We have core life insurance manufacturing entities, the majority of which are direct subsidiaries of legal banking entities, in seven countries (Argentina, Brazil, Mexico, France, the UK, Hong Kong and Singapore). There are also life insurance manufacturing subsidiaries in mainland China, Ireland (in run-off), Malaysia and Malta.

We measure the risk profile of our insurance manufacturing businesses using an economic capital approach, where assets and liabilities are measured on a market value basis and a capital requirement is held to ensure that there is less than a 1 in 200 chance of insolvency over the next year, given the risks that the businesses are exposed to. In 2014, we aligned the measurement approach for market, credit and insurance risks in the economic capital model to the new pan-European Solvency II insurance capital regulations applicable from 2016.

Further details of the management of financial risks and insurance risk arising from the insurance operations are provided from page 190 of the Annual Report and Accounts 2014.

Residual risk

Residual risk is, primarily, the risk that mitigation techniques prove less effective than expected. This category also includes risks from specific business events that give rise to exposures not deemed to be included in the major risk categories. We conduct economic capital assessments of such risks on a regular, forward-looking basis to ensure that their impact is adequately covered by our capital base.

Liquidity and funding risk

Liquidity risk is the risk that the Group does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. The risk arises from mismatches in the timing of cash flows.

The objective of our liquidity framework is to allow us to withstand very severe stresses. It is designed to be adaptable to changing business models, markets and regulations. Our Liquidity and funding risk management framework requires:

· liquidity to be managed by operating entities on a stand-alone basis with no implicit reliance on the Group or central banks;

· all operating entities to comply with their limits for the advances to core funding ratio; and

· all operating entities to maintain positive stressed cash flow positions out to three months under prescribed Group stress scenarios.

We do not manage liquidity through the explicit allocation of capital as, in common with standard industry practice, this is not considered to be an appropriate or adequate mechanism for managing these risks. However, we recognise that a strong capital base can help to mitigate liquidity risk.

Funding risk is a form of liquidity risk arising when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required. Our primary sources of funding are customer current accounts and customer savings deposits payable on demand or at short notice. We issue wholesale securities (secured and unsecured) to supplement our customer deposits and change the currency mix, maturity profile or location of our liabilities. In the normal course of business we do not seek to utilise secured financing as a source of funding to finance customer assets, beyond the collateralised security financing activities within Global Markets. The table in Appendix II summarises the total on and off-balance sheet assets that are encumbered and unencumbered on liquidity and funding risk basis and unencumbered assets that could be used to support potential future funding and collateral needs.

Details of our Liquidity and Funding Risk parameters are provided from page 164 of the Annual Report and Accounts 2014.

Reputational risk

Reputational risk is the failure to meet stakeholder expectations as a result of any event, behaviour, action or inaction, either by HSBC itself, our employees or those with whom we are associated, that might cause stakeholders to form a negative view of HSBC. Reputational risk relates to perceptions, whether based on fact or otherwise. Stakeholders' expectations are constantly changing and thus reputational risk is dynamic and varies between geographies, groups and individuals. As a global bank, HSBC shows unwavering commitment to operating, and to be seen to be operating, to the high standards we have set for ourselves in every jurisdiction. Reputational risk might result in financial or non-financial impacts, loss of confidence, adverse effects on our ability to keep and attract customers, or other consequences. Any lapse in standards of integrity, compliance, customer service or operating efficiency represents a potential reputational risk.

For further details, please refer to the Reputational Risk section on page 199 of the Annual Report and Accounts 2014.

Sustainability risk

Sustainability risks arise from the provision of financial services to companies or projects which run counter to the needs of sustainable development; in effect, this risk arises when the environmental and social effects outweigh economic benefits. Sustainability risk is implicitly covered for economic capital purposes in credit risk, where risks associated with lending to certain categories of customers and industries are embedded.

Business risk

The PRA specifies that banks, as part of their ICAAP, should review their exposure to business risk.

Business risk is the potential negative impact on profits and capital from the Group not meeting our strategic objectives, as a result of unforeseen changes in the business and regulatory environment, exposure to economic cycles and technological changes.

We manage and mitigate business risk through our risk appetite, business planning and stress testing processes, so that our business model and planned activities are monitored, resourced and capitalised consistent with the commercial, economic and risk environment in which the Group operates, and that any potential vulnerabilities of our business plans are identified at an early stage so that mitigating actions can be taken.

Dilution risk

Dilution risk is the risk that an amount receivable is reduced through cash or non-cash credit to the obligor, and arises mainly from factoring and invoice discounting transactions.

Where there is recourse to the seller, we treat these transactions as loans secured by the collateral of the debts purchased and do not report dilution risk for them. For our non-recourse portfolio, we do not report any dilution risk as we obtain an indemnity from the seller which indemnifies us against this risk. Moreover, factoring transactions involve lending at a discount to the face-value of the receivables which provides protection against dilution risk.

Details of our management of these risks may be found on the following pages of the Annual Report and Accounts 2014: liquidity and funding 164, reputational 199 and sustainability 201.

Remuneration

Details of the Group's remuneration policy, including details on the remuneration committee membership, activities, our remuneration strategy and tables showing the remuneration details of HSBC's Identified Staff and Material Risk Takers may be found on the Remuneration Policy on our website (http://www.hsbc.com/investor-relations/governance) and the Directors' Remuneration Report on pages 300-323 of the Annual Report and Accounts 2014.

Appendix I

Simplified organisation chart for regulatory purposes1

To view chart in PDF format please click on the link below:

http://www.rns-pdf.londonstockexchange.com/rns/5403F_-2015-2-22.pdf

1 At 31 December 2014 showing entities in Home and Priority Growth markets, wholly owned unless shown otherwise (part ownership rounded down to the nearest per cent), except 2, below.
2 Control of Special Purpose Entities is not based on ownership.
3 Middle East and North Africa.

Appendix II

Asset encumbrance

The following is the disclosure of encumbered and unencumbered assets (as at 31 Dec 2014) based on the requirement in Part Eight of the Capital Requirements Regulation and in the related Guideline issued by the European Banking Authority on 27 June 2014.

Template A - Assets

		Carrying amount of encumbered assets	Fair value of encumbered assets	Carrying amount of unencumbered assets	Fair value of unencumbered assets
		010	040	060	090
		US$m	US$m	US$m	US$m
010	Assets of the reporting institution	138,370	-	2,590,799	-
030	Equity instruments	10,857	10,857	75,486	75,364
040	Debt securities	112,294	112,288	442,741	442,605

120	Other assets	1,367	-	477,596	-

Template B - Collateral received

		Fair value of encumbered collateral received or own debt securities issued	Fair value of collateral received or own debt securities issued available for encumbrance
		010	040
		US$m	US$m
130	Assets of the reporting institution	141,701	118,173
150	Equity instruments	29,292	7,940
160	Debt securities	111,763	98,001
230	Other collateral received	-	995
240	Own debt securities issued other than own covered bonds or ABSs	-	-

Template C - Encumbered assets/collateral received and associated liabilities

		Matching liabilities, contingent liabilities or securities lent	Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered
		010	030
		US$m	US$m
010	Carrying amount of selected financial liabilities	172,547	268,477

Template D - Information on importance of encumbrance

We are a deposit-led bank and hence the majority of our funding is from customer accounts and customer savings deposits payable on demand or at short notice. This is part of our Group framework, where we have defined the limit for the ratio of Advances to Deposits to be below 90% (2014: 72%). Given this structural unsecured funding position we have little requirement to fund ourselves in secured markets, and therefore our overall low level of encumbrance reflects this position. However, we do provide collateralised financing services to clients as part of our Global Banking and

Markets business model, providing cash financing or specific securities, and these result in off-balance sheet encumbrance. The other sources which contribute to encumbrance are securities pledged in derivative transactions, mostly for hedging purposes; issuance of asset-backed securities, and covered bond programmes in the UK, France and Australia. HSBC Holdings ALCO reviews the asset encumbrance of the institution as a whole quarterly and any events causing change in the asset encumbrance level are examined.

Appendix III

Transitional own funds disclosure

	At 31 December 2014 US$m	CRR prescribed residual amount US$m	Final CRD IV text US$m
Common equity tier 1 (CET1) capital: instruments and reserves			
Capital instruments and the related share premium accounts	20,122	-	20,122
of which: ordinary shares	20,122	-	20,122
Retained earnings	135,589	-	135,589
Accumulated other comprehensive income (and other reserves)	13,648	-	13,648
Minority interests (amount allowed in consolidated CET1)	4,640	-	4,640
Independently reviewed interim net profits net of any foreseeable charge or dividend1	(2,742)	-	(2,742)
Common equity tier 1 capital before regulatory adjustments	171,257	-	171,257
Common equity tier 1 capital: regulatory adjustments			
Additional value adjustments	(1,341)	-	(1,341)
Intangible assets (net of related deferred tax liability)	(22,475)	-	(22,475)
Deferred tax assets that rely on future profitability excluding those arising from temporary differences (net of related tax liability)	(1,036)	-	(1,036)
Fair value reserves related to gains or losses on cash flow hedges	(57)	-	(57)
Negative amounts resulting from the calculation of expected loss amounts	(5,813)	-	(5,813)
Gains or losses on liabilities valued at fair value resulting from changes in own credit standing	570	-	570
Defined-benefit pension fund assets	(4,069)	-	(4,069)

Direct and indirect holdings of own CET1 instruments	(1,083)	-	(1,083)
Regulatory adjustments applied to common equity tier 1 in respect of amounts subject to pre-CRR treatment			
Regulatory adjustments relating to unrealised gains and losses	(2,753)	2,753	-
of which: unrealised gains on available-for-sale equities	(1,378)	1,378	-
of which: reserves arising from revaluation of property	(1,375)	1,375	-
Total regulatory adjustments to Common equity tier 1 (CET1)	(38,057)	2,753	(35,304)
Common equity tier 1 (CET1) capital	133,200	2,753	135,953
Additional Tier 1 (AT1) capital: instruments			
Capital instruments and the related share premium accounts	5,681	-	5,681
of which: classified as equity under applicable accounting standards	5,681	-	5,681
Amount of qualifying items and the related share premium accounts subject to phase out from AT1	9,874	(9,874)	-
Qualifying tier 1 capital included in consolidated AT1 capital (including minority interests not included in CET1) issued by subsidiaries and held by third parties	4,132	(3,735)	397
of which: instruments issued by subsidiaries subject to phase out	3,248	(3,248)	-
AT1 capital before regulatory adjustments	19,687	(13,609)	6,078
Additional Tier 1 capital: regulatory adjustments			
Residual amounts deducted from Additional Tier 1 capital with regard to deduction from Tier 2 capital during the transitional period	(148)	148	-
of which: Direct and indirect holdings by the institution of the T2 instruments and subordinated loans of financial sector entities where the institution has a significant investment in those entities	(148)	148	-
Total regulatory adjustments to Additional Tier 1 (AT1) capital	(148)	148	-
Additional Tier 1 (AT1) capital	19,539	(13,461)	6,078

Tier 1 capital (T1 = CET1 + AT1)	152,739	(10,708)	142,031

	At 31 December 2014	CRR prescribed residual amount	Final CRD IV text
	US$m	US$m	US$m
Tier 2 (T2) capital: instruments and provisions			
Capital instruments and the related share premium accounts	14,143	-	14,143
Amount of qualifying items and the related share premium accounts subject to phase out from T2	7,594	(7,594)	-
Qualifying own funds instruments included in consolidated T2 capital (including minority interests and AT1 instruments not included in CET1 or AT1) issued by subsidiaries and held by third parties	16,476	(15,981)	495
of which: instruments issued by subsidiaries subject to phase out	16,137	(16,137)	-
T2 capital before regulatory adjustments	38,213	(23,575)	14,638
Tier 2 (T2) capital: regulatory adjustments			
Direct and indirect holdings by the institution of the T2 instruments and subordinated loans of financial sector entities where the institution has a significant investment in those entities (net of eligible short positions)	(222)	(148)	(370)
Total regulatory adjustments to Tier 2 (T2) capital	(222)	(148)	(370)
Tier 2 (T2) capital	37,991	(23,723)	14,268
Total capital (TC = T1 + T2)	190,730	(34,431)	156,299

Total risk-weighted assets	1,219,765	-	1,219,765
Capital ratios and buffers			
Common equity Tier 1	10.9%		
Tier 1	12.5%		
Total capital	15.6%		
Institution specific buffer requirement			
of which: capital conservation buffer requirement			
of which: counter cyclical buffer requirement			
of which: systemic risk buffer requirement			
of which: Global Systemically Important Institution (G-SII) or Other Systemically Important Institution (O-SII) buffer			
Common Equity Tier 1 available to meet buffers	6.9%		
Amounts below the threshold for deduction (before risk weighting)			
Direct and indirect holdings of the capital of financial sector entities where the institution does not have a significant investment in those entities (amount below 10% threshold and net of eligible short positions)	2,459		
Direct and indirect holdings by the institution of the CET1 instruments of financial sector entities where the institution has a significant investment in those entities (amount below 10% threshold and net of eligible short positions)	9,123		
Deferred tax assets arising from temporary differences (amount below 10% threshold, net of related tax liability)	7,660		
Applicable caps on the inclusion of provisions in Tier 2			
Credit risk adjustments included in T2 in respect of exposures subject to standardised approach (prior to the application of the cap)	-		
Cap on inclusion of credit risk adjustments in T2 under standardised	4,453		

approach	
Credit risk adjustments included in T2 in respect of exposures subject to internal ratings-based approach (prior to the application of the cap)	-
Cap for inclusion of credit risk adjustments in T2 under internal ratings-based approach	3,266
Capital instruments subject to phase-out arrangements (only applicable between 1 January 2013 and 1 January 2022)	
Current cap on CET1 instruments subject to phase out arrangements	-
Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities)	-
Current cap on AT1 instruments subject to phase out arrangements	13,122
Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities)	833
Current cap on T2 instruments subject to phase out arrangements	23,971
Amount excluded from T2 due to cap (excess over cap after redemptions and maturities)	4,572

1 Following regulatory guidance, the prospective fourth interim dividend, net of projected scrip, has been deducted from the fourth interim profits.

CRD IV own funds disclosure requirements determine that firms must provide a detailed disclosure of the nature and amounts of specific items on own funds following an EBA specified uniform template. During the transitional period, the relevant template is the one set out in annex VI of Commission Implementing Regulation 1423/2013, which became applicable from 31 March 2014.

The capital position is presented on a CRD IV Year 1 transitional basis. Where appropriate, additional line items have been included to accommodate certain amounts not captured by the template. We have also

provided additional information in the column, 'CRR prescribed residual amount', for completeness, to facilitate the reading of the end point capital resources position which results from adding the two columns together.

A list of the features of our capital instruments in accordance with annex III of Commission Implementing Regulation 1423/2013 is also being published on our website with reference to our balance sheet on 31 December 2014. This is in addition to the full terms and conditions of our securities, also available on our website.

Appendix IV

Abbreviations

Abbreviation	Brief description
A	
ABS1	Asset-backed security
AFS1	Available-for-sale
ALCM	Asset, Liability and Capital Management
AMA	Advanced Measurement Approach
AT1 capital	Additional Tier 1 capital
B	
Basel Committee	Basel Committee on Banking Supervision
BIPRU	Prudential Sourcebook for Banks, Building Societies and Investment Firms
BoCom	Bank of Communications Co., Limited, one of China's largest banks
BRRD1	Bank Recovery and Resolution Directive
BSM	Balance Sheet Management
C	
CCB1	Capital conservation buffer
CCF1	Credit conversion factor
CCLB	Countercyclical leverage ratio buffer
CCP	Central counterparty
CCR1	Counterparty credit risk
CCyB1	Countercyclical capital buffer
CDS1	Credit default swap
CET11	Common equity tier 1
CIU	Collective investment undertakings
CML	Consumer and Mortgage Lending (US)
CPB1	Capital planning buffer
CRA1	Credit risk adjustment
CRD1	Capital Requirements Directive
CRE1	Commercial real estate
CRM1	Comprehensive risk measure
CRR1	Customer risk rating
CSA1	Credit Support Annex
CVA1	Credit valuation adjustment
E	
EAD1	Exposure at default
EBA	European Banking Authority
ECAI1	External Credit Assessment Institutions
EDTF	Enhanced Disclosure Task Force
EEA	European Economic Area
EL1	Expected loss
EU	European Union
EVE1	Economic value of equity
F	
FCA1	Financial Conduct Authority (UK)
FCCM1	Financial collateral comprehensive method
Fitch	Fitch Group

FPC1	Financial Policy Committee (UK)
FSB	Financial Stability Board
G	
GB&M	Global Banking and Markets, a global business
GCRO	Group Chief Risk Officer
GENPRU	The PRA's rules, as set out in the General Prudential Sourcebook
GMB	Group Management Board
GPB	Global Private Banking, a global business
GPSP	Group Performance Share Plan
GRC	Group Risk Committee
Group	HSBC Holdings together with its subsidiary undertakings

Abbreviation	Brief description
G-SIB1	Global systemically important bank
G-SII	Global systemically important institution
H	
HBUS	HSBC Bank USA NA
HNAH	HSBC North America Holdings Inc
Hong Kong	The Hong Kong Special Administrative Region of the People's Republic of China
HSBC	HSBC Holdings together with its subsidiary undertakings
I	
IAA1	Internal Assessment Approach
ICAAP1	Internal Capital Adequacy Assessment Process
ICG	Individual capital guidance
IFRSs	International Financial Reporting Standards
IMM1	Internal Model Method
IRB1	Internal ratings-based approach
IRC1	Incremental risk charge
ISDA	International Swaps and Derivatives Association
ITS	Implementing Technical Standards
L	
LFRF	Liquidity and funding risk management framework
LGD1	Loss given default
Libor	London Interbank Offer Rate
M	
MENA	Middle East and North Africa
MOC	Model Oversight Committee
Moody's	Moody's Investor Service
O	
OIS	Overnight Index Swap
ORMF	Operational risk management framework
O-SII	Other systemically important institution
OTC1	Over-the-counter
P	
PD1	Probability of default
PFE	Potential future exposure
PIT1	Point-in-time
PPI	Payment protection insurance product
PRA1	Prudential Regulation Authority (UK)

PS	Policy Statement
PVA1	Prudent valuation adjustment
PVIF	Present value of in-force long-term insurance business
Q	
QIS	Quantitative Impact Study
R	
RAS	Risk Appetite Statement
RBM1	Ratings Based Method
Retail IRB1	Retail Internal Ratings Based approach
RMM	Risk Management Meeting
RNIV	Risks not in VaR
RTS	Regulatory Technical Standard
RWA1	Risk-weighted asset
S	
S&P	Standard and Poor's rating agency
SFM1	Supervisory Formula Method
SFT1	Securities Financing Transactions
SIC	Securities Investment Conduit
SME	Small and medium-sized enterprise
SPE1	Special Purpose Entity
SRB1	Systemic Risk Buffer
STD1	Standardised approach
Abbreviation	Brief description
T	
TLAC1	Total Loss Absorbing Capacity
TTC1	Through-the-cycle
T2 capital	Tier 2 capital
U	
UK	United Kingdom
US$	United States dollar
US	United States of America
V	
VaR1	Value at risk
W	
WCMR	Wholesale Credit and Market Risk

1 Full definition included in Glossary at Appendix V.

Appendix V

Glossary

Term	Definition
A	
Additional value adjustment	See 'Prudent valuation adjustment'.
Arrears	Customers are said to be in arrears (or in a state of delinquency) when they are behind in fulfilling their obligations, with the result that an outstanding loan is unpaid or overdue. When a customer is in arrears, the total outstanding loans on which payments are overdue are

	described as delinquent.
Asset-backed securities ('ABS's)	Securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages.
Available-for-sale ('AFS') financial assets	Those non-derivative financial assets that are designated as available for sale or are not classified as a) loans and receivables b) held-to-maturity investments or c) financial assets at fair value through profit or loss.
B	
Back-testing	A statistical technique used to monitor and assess the accuracy of a model, and how that model would have performed had it been applied in the past.
Bank Recovery and Resolution Directive ('BRRD')	A European legislative package issued by the European Commission and adopted by EU Member States. This directive was finalised in July 2014 with the majority of provisions coming into effect 1 January 2015. This introduces a common EU framework for how authorities should intervene to address banks which are failing or are likely to fail. The framework includes early intervention and measures designed to prevent failure and in the event of bank failure for authorities to ensure an orderly resolution.
Basel II	The capital adequacy framework issued by the Basel Committee on Banking Supervision in June 2006 in the form of the 'International Convergence of Capital Measurement and Capital Standards'.
Basel 2.5	The update to Basel II including changes to capital and disclosure requirements for securitisation and market risk, which took effect in December 2011.
Basel III	In December 2010, the Basel Committee issued 'Basel III rules: a global regulatory framework for more resilient banks and banking systems' and 'International framework for liquidity risk measurement, standards and monitoring'. Together these documents present the Basel Committee's reforms to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector. In June 2011, the Basel Committee issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades.
Basis risk	The risk that prices of offsetting financial instruments in a hedging strategy will not move in entirely opposite directions from each other. There is therefore a risk that the imperfect correlation between the instruments used for the hedging strategy produces an overall gain or loss.

BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms.
C	
Capital conservation buffer ('CCB')	A capital buffer prescribed by regulators under Basel III and designed to ensure banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. Should a bank's capital levels fall within the capital conservation buffer range, capital distributions will be constrained by the regulators.
Capital planning buffer ('CPB')	A capital buffer, prescribed by the PRA under Basel II, designed to ensure banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. Should a bank's capital levels fall within the capital planning buffer range, a period of heightened regulatory interaction would be triggered.
Capital required	Capital required represents the Pillar 1 capital charge calculated at 8% of RWAs.

Term	Definition
Capital requirements directive ('CRD')	A capital adequacy legislative package issued by the European Commission and adopted by EU member states. The first CRD legislative package gave effect to the Basel II proposals in the EU and came into force on 20 July 2006. CRD II, which came into force on 31 December 2010, subsequently updated the requirements for capital instruments, large exposure, liquidity risk and securitisation. A further CRD III amendment updated market risk capital and additional securitisation requirements and came into force on 31 December 2011. The CRD IV package comprises a recast Capital Requirements Directive and a new Capital Requirements Regulation. The package implements the Basel III capital proposals together with transitional arrangements for some of its requirements. CRD IV proposals came into force on 1 January 2014.
Capital resources	Capital held on balance sheet that is eligible to satisfy capital requirements.
CET 1 ratio	A Basel III measure, of CET 1 capital expressed as percentage of total risk exposure amount.
Code Staff	Senior management, risk takers, staff engaged in control functions, and any employee whose total remuneration takes them into the same remuneration bracket as senior

	management and risk takers and whose professional activities have a material impact on the firm's risk profile.
Commercial paper ('CP')	An unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories and meeting short-term liabilities. The debt is usually issued at a discount, reflecting prevailing market interest rates.
Commercial real estate	Any real estate, comprising buildings or land, intended to generate a profit, either from capital gain or rental income.
Common equity tier 1 capital ('CET1')	The highest quality form of regulatory capital under Basel III that comprises common shares issued and related share premium, retained earnings and other reserves excluding the cash flow hedging reserve, less specified regulatory adjustments.
Comprehensive risk measure ('CRM')	The comprehensive risk measure model covers all positions that are part of the correlation trading portfolio. Comprehensive risk measure covers all price risks including spread, default and migration. Like incremental risk charge, it is calibrated to a 99.9 percentile loss and a one-year capital horizon to generate a capital add-on to VAR.
Conduits	HSBC sponsors and manages multi-seller conduits and SICs. The multi-seller conduits hold interests in diversified pools of third-party assets such as vehicle loans, trade receivables and credit card receivables funded through the issuance of short-dated commercial paper and supported by a liquidity facility. The SICs hold predominantly asset-backed securities referencing such items as commercial and residential mortgages, vehicle loans and credit card receivables funded through the issuance of both long-term and short-term debt.
Consumer and Mortgage Lending ('CML')	In the US, the CML portfolio consists of our Consumer Lending and Mortgage Services businesses, which are in run-off. The Consumer Lending business offered secured and unsecured loan products, such as first and second lien mortgage loans, open-ended home equity loans and personal non-credit card loans through branch locations and direct mail. The majority of the mortgage lending products were for refinancing and debt consolidation rather than home purchases. In the first quarter of 2009, we discontinued all originations by our Consumer Lending business. Prior to the first quarter of 2007, when we ceased loan purchase activity, the Mortgage Services business purchased non-conforming first and second lien real estate secured

	loans from unaffiliated third parties. The business also included the operations of Decision One Mortgage Company ('Decision One'), which historically originated mortgage loans sourced by independent mortgage brokers and sold these to secondary market purchasers. Decision One ceased originations in September 2007.
Core tier 1 capital	The highest quality form of regulatory capital under Basel II that comprised total shareholders' equity and related non-controlling interests, less goodwill and intangible assets and certain other regulatory adjustments.
Core tier 1 ratio	A Basel II measure, of core tier 1 capital expressed as a percentage of the total risk-weighted assets.
Countercyclical capital buffer ('CCyB')	A capital buffer prescribed by regulators under Basel III which aims to ensure that capital requirements take account of the macro-financial environment in which banks operate. This will provide the banking sector with additional capital to protect it against potential future losses, when excess credit growth in the financial system as a whole is associated with an increase in system-wide risk.
Counterparty credit risk ('CCR')	Counterparty credit risk, in both the trading and non-trading books, is the risk that the counterparty to a transaction may default before completing the satisfactory settlement of the transaction.
Term	Definition
CRD III	See 'Capital requirements directive'.
CRD IV	See 'Capital requirements directive'.
Credit Conversion Factor ('CCF')	CCFs are used in determining the EAD in relation to credit risk exposures. The CCF is an estimate of the proportion of undrawn commitments expected to have been drawn down at the point of default.
Credit default swap ('CDS')	A derivative contract whereby a buyer pays a fee to a seller in return for receiving a payment in the event of a defined credit event (e.g. bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency) on an underlying obligation (which may or may not be held by the buyer).
Credit enhancements	Facilities used to enhance the creditworthiness of financial obligations and cover losses due to asset default.
Credit quality step	A step in the PRA credit quality assessment scale which is based on the credit ratings of ECAIs. It is used to assign risk

	weights under the standardised approach.
Credit risk	Risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises mainly from direct lending, trade finance and leasing business but also from products such as guarantees, derivatives and debt securities.
Credit risk adjustment	Credit risk adjustments are all amounts by which CET 1 has been reduced in order to reflect losses exclusively related to credit risk under IFRSs, resulting from impairments, value adjustments or provisions for off-balance sheet items that are recognised in the profit or loss account.
Credit risk mitigation	A technique to reduce the credit risk associated with an exposure by application of credit risk mitigants such as collateral, guarantees and credit protection.
Credit spread option	A derivative that transfers risk from one party to another. The buyer pays an initial premium in exchange for potential cash flows if the credit spread changes from its current level.
Credit Support Annex ('CSA')	A legal document that regulates credit support (collateral) for OTC derivative transactions between two parties.
Customer risk rating ('CRR')	An internal scale of 23 grades measuring obligor PD.
CVA risk capital charge	A capital charge under CRD IV to cover the risk of mark-to-market losses on expected counterparty risk to derivatives.
D	
Debit valuation adjustment ('DVA')	An adjustment made by an entity to the valuation of OTC derivative liabilities to reflect within fair value the entity's own credit risk.
Debt securities	Financial assets on the Group's balance sheet representing certificates of indebtedness of credit institutions, public bodies or other undertakings, excluding those issued by central banks.
Delinquency	See 'Arrears'.
E	
Economic capital	The internally calculated capital requirement which is deemed necessary by HSBC to support the risks to which it is exposed.
Economic Value of Equity ('EVE')	Considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks.
Equity risk	

	The risk arising from positions, either long or short, in equities or equity-based instruments, which create exposure to a change in the market price of the equities or equity instruments.
Expected loss ('EL')	A regulatory calculation of the amount expected to be lost on an exposure using a 12-month time horizon and downturn loss estimates. EL is calculated by multiplying the PD (a percentage) by the EAD (an amount) and LGD (a percentage).
Exposure	A claim, contingent claim or position which carries a risk of financial loss.
Exposure at default ('EAD')	The amount expected to be outstanding after any credit risk mitigation, if and when the counterparty defaults. EAD reflects drawn balances as well as allowance for undrawn amounts of commitments and contingent exposures.
Exposure value	Exposure at default.
External Credit Assessment Institutions ('ECAI')	ECAIs include external credit rating agencies such as Standard & Poor's, Moody's and Fitch.
F	
Fair value	Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Term	Definition
Financial collateral comprehensive method	This method applies a volatility adjustment (or 'haircut') to the value of the collateral to allow for the fact that the collateral taken may fall in value when it comes to taking control of the collateral and selling it. This adjusted collateral value is then subtracted from the exposure to create an 'adjusted exposure'. Firms on the standardised approach will then apply the risk weight of the borrower to the adjusted exposure value, while firms using foundation IRB make a formulaic adjustment to the LGD number which has a similar effect. To calculate these 'haircuts', the firm can use either a table of supervisory numbers or its own numbers if it meets certain requirements.
Financial Conduct Authority ('FCA')	The Financial Conduct Authority regulates the conduct of financial firms and, for certain firms, prudential standards in the UK. It has a strategic objective to ensure that the relevant markets function well.
Financial Policy Committee ('FPC')	The Financial Policy Committee, at the Bank of England, is charged with a primary objective of identifying, monitoring

	and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the UK Government.
Firm Data Submission Framework	A comprehensive framework for the submission of the data by banks to the PRA for the purpose of conducting stress tests. Over the past two years it has been designed and implemented by the PRA (and before that the FSA) in collaboration with a number of large UK banks.
G	
Global Systemically Important Bank ('G-SIB')	The FSB established in November 2011 a methodology to identify G-SIBs based on 12 principal indicators. Designation will result in the application of a CET1 buffer between 1% and 3.5%, to be phased in by 1 January 2019. The list of G-SIBs is re-assessed through annual re-scoring of banks and a triennial review of the methodology. National regulators have discretion to introduce higher charges than the minima. In CRD IV this is implemented via the Global Systemically Important Institutions (G-SII) Buffer. The requirements, initially for those banks identified in November 2014 as G-SIBs, will be phased in from 1 January 2016, becoming fully effective on 1 January 2019. National regulators have discretion to introduce higher thresholds than the minima. In November 2014, the FSB published a revised list of G-SIBs and their current assessment of the appropriate capital charge. HSBC was assigned an add-on of 2.5%.
H	
Haircut	A discount applied by management when determining the amount at which an asset can be realised. The discount takes into account the method of realisation including the extent to which an active market for the asset exists. With respect to credit risk mitigation, a downward adjustment to collateral value to reflect any currency or maturity mismatches between the credit risk mitigant and the underlying exposure to which it is being applied. Also a valuation adjustment to reflect any fall in value between the date the collateral was called and the date of liquidation or enforcement.
Held-to-maturity	An accounting classification for investments acquired with the intention and ability of being held until they mature.
I	
Impaired loans	Loans where the Group does not expect to collect all the contractual cash flows or expects to collect them later than they are contractually due.

Impairment allowances	Management's best estimate of losses incurred in the loan portfolios at the balance sheet date.
Impairment charge	Impairment charges represent a movement in the impairment allowance balance during the year, reflecting loss events which occurred during the financial year and changes in estimates of losses arising on events which occurred prior to the current year.
Incremental risk charge ('IRC')	The IRC model captures the potential distribution of profit and loss due to default and migration for a portfolio of credit positions. For credit positions held on the trading book, and subject to specific interest rate risk VAR for regulatory capital, an IRC based on the 99.9th percentile of the IRC distribution, over a one-year capital horizon, is used as a capital add-on to VAR
Institutions	Under the standardised approach, Institutions comprise credit institutions or investment firms. Under the IRB approach, Institutions also include regional governments and local authorities, public sector entities and multilateral development banks.

Term	Definition
Insurance risk	A risk, other than financial risk, transferred from the holder of a contract to the insurance provider. The principal insurance risk is that, over time, the combined cost of claims, administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income.
Interest rate risk ('IRR')	Exposure to adverse movements in interest rates. Accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value.
Internal Assessment Approach ('IAA')	One of three calculation methods defined under the IRB approach to securitisations. The IAA is limited to exposures arising from asset-backed commercial paper programmes, mainly related to liquidity facilities and credit enhancement. Eligible ECAI rating methodology is applied to each asset class in order to derive the equivalent rating level for each transaction. This methodology is verified by the internal Credit function as part of the approval process for each new transaction. The performance of each underlying asset portfolio is monitored to confirm that the applicable equivalent rating level still applies and is independently verified.

Internal Capital Adequacy Assessment Process ('ICAAP')	The Group's own assessment of the levels of capital that it needs to hold through an examination of its risk profile from regulatory and economic capital viewpoints.
Internal Model Method ('IMM')	One of three approaches defined in the Basel framework to determine exposure values for counterparty credit risk.
Internal ratings-based approach ('IRB')	A method of calculating credit risk capital requirements using internal, rather than supervisory, estimates of risk parameters.
Invested capital	Equity capital invested in HSBC by its shareholders, adjusted for certain reserves and goodwill previously amortised or written off.
IRB advanced approach ('AIRB')	A method of calculating credit risk capital requirements using internal PD, LGD and EAD models.
IRB foundation approach ('FIRB')	A method of calculating credit risk capital requirements using internal PD models but with supervisory estimates of LGD and conversion factors for the calculation of EAD.
ISDA	International Swaps and Derivatives Association.
ISDA Master agreement	Standardised contract developed by ISDA used as an umbrella contract under which bilateral derivatives contracts are entered into.
L	
Leverage ratio	A measure, prescribed by regulators under Basel III, which is the ratio of tier 1 capital to total exposures. Total exposures include on-balance sheet items, off-balance sheet items and derivatives, and should generally follow the accounting measure of exposure. This supplementary measure to the risk-based capital requirements is intended to constrain the build-up of excess lending in the banking sector.
Liquidity risk	The risk that HSBC does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows.
Loss given default ('LGD')	The estimated ratio (percentage) of the loss on an exposure to the amount outstanding at default (EAD) upon default of a counterparty.
M	
Market risk	The risk that movements in market risk factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices will reduce income or

	portfolio values.
Mark-to-market approach	One of three approaches defined by Basel II to determine exposure values for counterparty credit risk.
Minimum capital requirement	The minimum amount of regulatory capital that a financial institution must hold to meet the Pillar 1 requirements for credit, market and operational risk. Also see 'capital required'.
Model validation	The process of assessing how well a credit risk model performs using a predefined set of criteria including the discriminatory power of the model, the appropriateness of the inputs, and expert opinion.
Multilateral Development Bank	An institution created by a group of countries to provide financing for the purpose of development. Under the standardised approach to credit risk, eligible multilateral development banks attract a zero per cent risk weight.
N	
Net interest income	The amount of interest received or receivable on assets net of interest paid or payable on liabilities.

Term	Definition
O	
Obligor grade	Obligor grades, summarising a more granular underlying counterparty risk rating scale for estimates of PD, are defined as follows: · 'Minimal Default Risk': The strongest credit risk, with a negligible PD. · 'Low Default Risk': A strong credit risk, with a low PD. · 'Satisfactory Default Risk': A good credit risk, with a satisfactory PD. · 'Fair Default Risk': The risk of default remains fair, but identified weaknesses may warrant more regular monitoring. · 'Moderate Default Risk': The overall position will not be causing any immediate concern, but more regular monitoring will be necessary as a result of sensitivities to external events that give rise to the possibility of risk of default increasing. · 'Significant Default Risk': Performance may be limited by one or more troublesome aspects, known deterioration, or the prospect of worsening financial status. More regular monitoring required. · 'High Default Risk': Continued deterioration in financial status, that requires frequent monitoring and ongoing assessment. The PD is of concern but the borrower currently has the capacity to meet its financial commitments.

· 'Special Management': The PD is of increasing concern and the borrower's capacity to fully meet its financial commitments is becoming increasingly less likely.
· 'Default': A default is considered to have occurred with regard to a particular obligor when either or both of the following events has taken place: the Group considers that the obligor is unlikely to pay its credit obligations in full, without recourse by the Group to actions such as realising security; or the obligor is past due more than 90 days, (90 days to 180 days for retail), on any material credit obligation to the Group.

Operational risk	The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including legal risk.
Original exposure	Original exposure is the exposure value without taking into account value adjustments and provisions, credit conversion factors and the effect of credit risk mitigation techniques.
Over-the-counter ('OTC')	A bilateral transaction (e.g. derivatives) that is not exchange traded and that is valued using valuation models.
P	
Past due items	'Past due items' is an exposure class under the standardised approach to credit risk. A financial asset falls into this exposure class once it is more than 90 days past due. A financial asset such as a loan is past due when the counterparty has failed to make a payment when contractually due.
Pillar 1	Minimum capital requirements - the calculation of regulatory capital for credit, market, and operational risk.
Pillar 2	The supervisory review process - sets out the process by which a bank should review its overall capital adequacy and the processes under which the supervisors evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments.
Pillar 3	Market discipline - sets out the disclosure requirements for banks to publish certain details of their risks, capital and risk management, with the aim of strengthening market discipline.
Point-in-time ('PIT')	Estimates of PD (or other measures) generally covering a short time horizon (usually a 12-month period) and that are sensitive to changes in the economic cycle. This differs from a TTC basis which uses long run average economic and risk data to reduce such sensitivity.
Potential future exposure ('PFE')	The potential future credit exposure on derivatives contracts, calculated using the mark-to-market approach.
PRA Standard rules	The method prescribed by the PRA for calculating market risk capital requirements in the absence of VAR model approval.
Present value of in-force long-term insurance	An asset representing the present value of the equity holders' interest in the issuing insurance companies' profits, expected to emerge from long-term insurance business or

business ('PVIF')	long-term investment contracts with discretionary participating features, written at the balance sheet date.
Private equity investments	Equity securities in operating companies not quoted on a public exchange, often involving the investment of capital in private companies or the acquisition of a public company that results in its delisting.
Probability of default ('PD')	The probability that an obligor will default within one year.

Term	Definition
Prudential Regulation Authority ('PRA')	The Prudential Regulation Authority in the UK is responsible for prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms.
Prudent Valuation Adjustment ('PVA')	A deduction from common equity tier 1 capital where the prudent value of trading assets or other financial assets measured at fair value is materially lower than the fair value recognised in the financial statements.
Q	
Qualifying revolving retail exposures	Retail IRB exposures that are revolving, unsecured, and, to the extent they are not drawn, immediately and unconditionally cancellable, such as credit cards.
R	
Ratings Based Method ('RBM')	One of three calculation methods defined under the IRB approach to securitisations. The approach uses risk weightings based on ECAI ratings, the granularity of the underlying pool and the seniority of the position and whether it is a re-securitisation.
Reference PD	HSBC's master CRR scale has been constructed using a set of PD points, falling at regular intervals along an exponential PD curve and determining the boundaries of 23 CRR bands. Reference PDs have been determined, which for most bands fall mid-way between that band's boundary PD points. The determination of the bands and corresponding reference PDs takes into account the need to avoid concentration in any one band, and to ensure effective mapping to risk management portfolio quality scales.
Regulatory capital	The capital which HSBC holds, determined in accordance with rules established by the PRA for the consolidated Group and by local regulators for individual Group companies.
Repo/reverse repo (or sale and repurchase agreement)	A short-term funding agreement that allows a borrower to create a collateralised loan by selling a financial asset to a lender. As part of the agreement the borrower commits to

	repurchase the security at a date in the future repaying the proceeds of the loan. For the party on the other end of the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or a reverse repo.
Re-securitisation	A securitisation of a securitisation exposure, where the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure.
Residential Mortgaged Backed Securities ('RMBSs')	A type of security whose cash flows come from residential debt such as mortgages, home-equity loans and subprime mortgages.
Residual maturity	The period outstanding from the reporting date to the maturity or end date of an exposure.
Retail Internal Ratings Based ('Retail IRB') approach	Retail exposures that are treated under the IRB approach.
Return on equity	Profit attributable to ordinary shareholders of the parent company divided by average ordinary shareholders' equity.
Risk appetite	The aggregate level and types of risk a firm is willing to assume within its risk capacity to achieve its strategic objectives and business plan.
Risk-weighted assets ('RWAs')	Calculated by assigning a degree of risk expressed as a percentage (risk weight) to an exposure value in accordance with the applicable Standardised or IRB approach rules.
RMM	Risk Management Meeting of the GMB.
Run-off portfolios	Legacy credit in GB&M, the US CML portfolio and other US run-off portfolios, including the treasury services related to the US CML businesses and commercial operations in run-off. Origination of new business in the run-off portfolios has been discontinued and balances are being managed down through attrition and sale.
RWA density	The average risk weight, expressed as a percentage of RWAs divided by exposure value, based on those RWA and exposure value numbers before they are rounded to the nearest US$0.1bn for presentation purposes.
S	
Securities Financing Transactions ('SFT')	The act of loaning a stock, derivative, or other security to an investor or firm.
Securitisation	

	A transaction or scheme whereby the credit risk associated with an exposure, or pool of exposures, is tranched and where payments to investors in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures. A traditional securitisation involves the transfer of the exposures being securitised to an SPE which issues securities. In a synthetic securitisation, the tranching is achieved by the use of credit derivatives and the exposures are not removed from the balance sheet of the originator.
Securitisation position	Securitisation position means an exposure to a securitisation.

Term	Definition
Significant Influence Function	PRA registered role, recognised as being a control function role.
Six filters	An internal measure designed to improve capital deployment across the Group. Five of the filters examine the strategic relevance of each business in each country, in terms of connectivity and economic development, and the current returns, in terms of profitability, cost efficiency and liquidity. The sixth filter requires adherence to global risk standards.
Sovereign exposures	Exposures to governments, ministries, departments of governments, embassies, consulates and exposures on account of cash balances and deposits with central banks.
Specialised lending exposure	Specialised lending exposures are defined by the PRA as exposures to an entity which was created specifically to finance and/or operate physical assets, where the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate and the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.
Special Purpose Entity ('SPE')	A corporation, trust or other non-bank entity, established for a narrowly defined purpose, including for carrying on securitisation activities. The structure of the SPE and its activities are intended to isolate its obligations from those of the originator and the holders of the beneficial interests in the securitisation.
Specific issuer risk	Specific issuer (credit spread) risk arises from a change in the value of debt instruments due to a perceived change in the credit quality of the issuer or underlying assets.
Standardised approach ('STD')	

	In relation to credit risk, a method for calculating credit risk capital requirements using ECAI ratings and supervisory risk weights. In relation to operational risk, a method of calculating the operational capital requirement by the application of a supervisory defined percentage charge to the gross income of eight specified business lines.
Stressed VaR	A market risk measure based on potential market movements for a continuous one-year period of stress for a trading portfolio.
Subordinated liabilities	Liabilities which rank after the claims of other creditors of the issuer in the event of insolvency or liquidation.
Supervisory Formula Method('SFM')	An alternative Ratings Based Method to be used primarily on sponsored securitisations. It is used to calculate the capital requirements of exposures to a securitisation as a function of the collateral pool and contractual properties of the tranche or tranches retained.
Supervisory slotting approach	A method for calculating capital requirements for specialised lending exposures where the internal rating of the obligor is mapped to one of five supervisory categories, each associated with a specific supervisory risk weight.
Systemic Risk Buffer	A capital buffer prescribed in the EU under CRD IV, to address risks in the financial sector as a whole, or one or more sub-sectors, to be deployed as necessary by each EU member state with a view to mitigate structural macro-prudential risk. In the UK this was transposed in January 2015 and is to be applied to ring-fenced banks and building societies over a certain threshold.
T	
Through-the-cycle ('TTC')	A rating methodology which seeks to take cyclical volatility out of the estimation of default risk by assessing a borrower's performance over the business cycle.
Tier 2 capital	A component of regulatory capital, comprising eligible capital securities and any related share premium. Under Basel II, Tier 2 capital comprises of qualifying subordinated loan capital, related non-controlling interests, allowable collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available-for-sale. Tier 2 capital also includes reserves arising from the revaluation of properties.
Total Loss Absorbing Capacity	A proposal by the FSB and not yet finalised for global systemically important banks to have a sufficient amount of specific types of liabilities which can be used to absorb losses and recapitalise a bank in resolution. These proposals are intended to facilitate an orderly resolution that minimises any impact on financial stability, ensures the continuity of critical functions, and avoids exposing taxpayers to loss.
Total return swap	A credit derivative transaction that swaps the total return on a financial instrument (cash flows and capital gains and losses), for a guaranteed interest rate, such as an inter-bank rate, plus a margin.
Trading book	Positions in financial instruments and commodities held either with intent to trade or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants

on their tradability or able to be hedged completely.

Term	Definition
V	
Value at risk ('VaR')	A measure of the loss that could occur on risk positions as a result of adverse movements in market risk factors (e.g. rates, prices, volatilities) over a specified time horizon and to a given level of confidence.
W	
Write-down/write-off	When a financial asset is written down or written off, a customer balance is partially or fully removed, respectively, from the balance sheet. Loans (and related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write-off may be earlier.
Wrong-way risk	An adverse correlation between the counterparty's PD and the mark-to-market value of the underlying transaction.

Appendix VI

Contacts

Enquiries relating to HSBC's strategy or operations may be directed to:

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SIGNATURE

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

HSBC Holdings plc

By:

Name: Ben J S Mathews

Title: Group Company Secretary

Date: 23 February 2015