

SHANDA INTERACTIVE ENTERTAINMENT LTD

Form 20-F

May 31, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 20-F**

(Mark One)

- o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

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

For the fiscal year ended December 31, 2004

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 000-50705

**SHANDA INTERACTIVE ENTERTAINMENT LIMITED**

(Exact name of Registrant as specified in its charter)

**N/A**

(Translation of Registrant's name into English)

**Cayman Islands**

(Jurisdiction of incorporation or organization)

**No. 1 Office Building**

**No. 690 Bibo Road**

**Pudong New Area**

**Shanghai 201203, People's Republic of China**

(Address of principal executive offices)

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

**None**

(Title of each class)

(Name of each exchange on which registered)

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

**American Depositary Shares, each representing 2 ordinary shares, par value  
\$0.01 per share**  
(Title of each class)

Securities for which there is a reporting obligation pursuant to Section 15(d)  
of the Act:

**None**

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 139,960,328 ordinary shares, par value \$0.01 per share.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17  Item 18

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**Introduction**

**CONVENTIONS WHICH APPLY TO THIS FORM**

Except where the context otherwise requires and for purposes of this form only:

we, us, our company and our refer to Shanda Interactive Entertainment Limited, its predecessor entities and subsidiaries, and, in the context of describing our operations, also include our PRC-incorporated affiliates, including Shanghai Shanda Networking Co., Ltd., or Shanda Networking, Nanjing Shanda Networking Co., Ltd., or Nanjing Shanda, and Hangzhou Bianfeng Networking Co., Ltd., or Hangzhou Bianfeng;

in certain instances, Shanghai Shanda Networking, Nanjing Shanda Networking, and Hangzhou Bianfeng Networking are referred to collectively as our PRC operating companies ;

in certain instances, Shanda Networking is referred to as Shanghai Shanda Internet Development Co., Ltd. , which is an alternative English translation of its Chinese name;

China or PRC refers to the People s Republic of China, excluding Taiwan, Hong Kong and Macau; and

all references to RMB or Renminbi are to the legal currency of China and all references to U.S. dollars, dollar and US\$ are to the legal currency of the United States.

This form contains translations of Renminbi amounts into U.S. dollars at specified rates solely for the convenience of the reader. Unless otherwise noted, all translations from Renminbi to U.S. dollars were made at the noon buying rate in The City of New York for cable transfers in Renminbi per U.S. dollar as certified for customs purposes by the Federal Reserve Bank of New York, or the noon buying rate, as of December 31, 2004 which was RMB8.2765 to US\$1.00. We make no representation that the Renminbi amounts referred to in this form could have been or could be converted into U.S. dollars at any particular rate or at all. On May 26, 2005, the noon buying rate was RMB8.2765 to US\$1.00.

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This form contains forward-looking statements that are based on our current expectations, assumptions, estimates and projections about us and our industry. All statements other than statements of historical fact in this form are forward-looking statements. These forward-looking statements can be identified by words or phrases such as may , will , expect , anticipate , estimate , plan , believe , is/are likely to or other similar expressions. The forward-looking statements included in this form relate to, among others:

our goals and strategies;

our future business development, financial condition and results of operations;

our projected revenues, earnings, profits and other estimated financial information;

expected changes in our margins and certain costs or expenditures;

our plans to expand and diversify the sources of our revenues;

expected changes in the respective shares of our revenues from particular sources;

our plans for staffing, research and development and regional focus;

the projected economic lifespan of our current games, and our plans to launch new in-house developed

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games and license additional games from third parties, including the timing of any such launches or licenses;

our plans to launch new products, including movies and music content;

our plans for strategic partnerships with other businesses;

our acquisition strategy, and our ability to successfully integrate past or future acquisitions with our existing operations;

our estimates of earn-out payments and other obligations relating to our acquisitions and investments;

the development of other delivery platforms for online games, including online game consoles and mobile phones;

competition in the PRC online game industry;

the outcome of ongoing, or any future, litigation or arbitration;

the outcome of our annual PFIC evaluations;

the expected growth in the number of Internet and broadband users in China, growth of personal computer penetration and developments in the ways most people in China access the Internet;

changes in PRC governmental financial incentives we currently qualify for and expect to qualify for; and

PRC governmental policies relating to the Internet and Internet content providers and to the provision of advertising over the Internet.

These forward-looking statements involve various risks and uncertainties. Although we believe that our expectations expressed in these forward-looking statements are reasonable, we cannot assure you that our expectations will turn out to be correct. Our actual results could be materially different from and worse than our expectations. Important risks and factors that could cause our actual results to be materially different from our expectations are generally set forth in the Risk Factors section of Item 3 and elsewhere in this form.

This form also contains data related to the online game market and the Internet. These market data include projections that are based on a number of assumptions. The online game market may not grow at the rates projected by the market data, or at all. The failure of the market to grow at the projected rates may have a material adverse effect on our business and the market price of our American Depositary Shares, or ADSs. In addition, the relatively new and rapidly changing nature of the online game industry subjects any projections or estimates relating to the growth prospects or future condition of our market to significant uncertainties. Furthermore, if any one or more of the assumptions underlying the market data turns out to be incorrect, actual results may differ from the projections based on these assumptions. You should not place undue reliance on these forward-looking statements.

The forward-looking statements made in this form relate only to events or information as of the date on which the statements are made in this form. We undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date on which the statements are made or to reflect the occurrence of unanticipated events.



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**Item 1. Identity of Directors, Senior Management and Advisors**

Not Applicable

**Item 2. Offer Statistics and Expected Timetable**

Not Applicable

**Item 3. Key Information**

**A. SELECTED FINANCIAL DATA**

The following summary consolidated financial information has been derived from our consolidated financial statements included elsewhere in this annual report. Our statements of operations and comprehensive income for the years ended December 31, 2001, 2002, 2003 and 2004 and our balance sheets as of December 31, 2001, 2002, 2003 and 2004 have been audited by PricewaterhouseCoopers Zhong Tian Certified Public Accountants Ltd. Co. independent registered public accounting firm, or PricewaterhouseCoopers. The report of PricewaterhouseCoopers on the consolidated statements of operations and comprehensive income for the years ended December 31, 2002, 2003 and 2004 and the consolidated balance sheets as of December 31, 2003 and 2004 are included elsewhere in this annual report. The summary consolidated financial information for those periods and as of those dates should be read in conjunction with those statements and the accompanying notes and the discussion set forth in Item 5, Operating and Financial Review and Prospects . Our consolidated financial information as of December 31, 2000, which was the first full year of our operations and prior to significant growth of our business, has been derived from our unaudited consolidated financial statements which are not included in this annual report, but which have been prepared on the same basis as our audited consolidated financial statements.

Our consolidated financial statements are prepared and presented in accordance with generally accepted accounting principles in the United States, or U.S. GAAP, reflect our recent reorganization, and have been prepared as if our current corporate structure had been in existence throughout the relevant periods.

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	For the year ended December 31,					
	2000 RMB (unaudited)	2001 RMB	2002 RMB	2003 RMB	2004 RMB	US\$( <sup>3</sup> )
	(In thousands)					
<b>Consolidated Statements of Operations and Comprehensive Income Data</b>						
Net revenues:						
Online game net revenues:						
MMORPGs		3,871	326,127	580,315	994,664	120,179
Casual				8,313	214,513	25,918
Other revenues	2,375	681	94	11,352	89,548	10,820
Total net revenues	2,375	4,552	326,221	599,980	1,298,725	156,917
Cost of services		(1,970)	(122,081)	(233,701)	(471,184)	(56,930)
Gross profit	2,375	2,582	204,140	366,279	827,541	99,987
Operating expenses	(596)	(8,917)	(41,516)	(153,106)	(316,579)	(38,250)
Income (loss) from operations	1,779	(6,335)	162,624	213,173	510,962	61,737
Interest income and investment income	(66)	205	1,112	13,531	63,171	7,632
Amortization of convertible debt issuance cost					(3,524)	(426)
Other income (expense), net	(1)	(18)	(1,371)	61,152	83,656	10,108
Income (loss) before income tax benefits (expenses), equity in loss of affiliated companies, minority interests and extraordinary gain	1,712	(6,148)	162,365	287,856	654,265	79,051
Income tax benefits (expenses)		87	(23,077)	(18,647)	(38,941)	(4,705)
Equity in loss of affiliated companies					(4,180)	(505)
Minority interests		4,781	0	3,641	(1,661)	(201)
Extraordinary gain arising from acquisition of a company		4,516				
Net income	1,712	3,236	139,288	272,850	609,483	73,640

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	For the year ended December 31,					
	2000 RMB (unaudited)	2001 RMB	2002 RMB	2003 RMB	2004 RMB	2004 US\$ <sup>(1)</sup>
	(In thousands except for per share data)					
<b>Earnings per Share Data:</b>						
Accretion for preferred shares				(24,963)		
Income attributable to preferred shareholders				(48,358)	(82,479)	(9,965)
Income attributable to ordinary shareholders	1,712	3,236	139,288	199,529	527,004	63,675
Earnings per share, basic <sup>(2)</sup>	0.02	0.03	1.39	2.14	4.32	0.52
Earnings per share, diluted <sup>(2)</sup>	0.02	0.03	1.39	2.07	4.05	0.49
Earnings per ADS <sup>(3)</sup> , basic <sup>(2)</sup>	0.04	0.06	2.78	4.28	8.64	1.04
Earnings per ADS <sup>(3)</sup> , diluted <sup>(2)</sup>	0.04	0.06	2.78	4.14	8.10	0.98

	As of December 31,					
	2000 RMB (unaudited)	2001 RMB	2002 RMB	2003 RMB	2004 RMB	2004 US\$ <sup>(3)</sup>
	(in thousands)					
<b>Consolidated Balance Sheets Data:</b>						
Cash and cash equivalents	3,280	7,791	177,040	598,922	3,123,971	377,451
Working capital <sup>(4)</sup>	2,026	1,841	99,080	459,445	3,310,680	400,010
Total assets	5,118	16,300	404,695	928,978	4,282,035	517,373
Total liabilities	2,907	9,353	258,629	303,661	2,774,387	335,213
Minority interests				2,716	6,879	831
Total shareholders equity	2,211	6,947	146,066	622,601	1,500,769	181,329

(1) Translations of RMB amounts into U.S. dollars were made at a rate of RMB8.2765 to US\$1.00, the noon buying rate in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York on December 31, 2004.

(2) In March 2004, the Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 03-06, Participating Securities and the Two-Class Method under FASB Statement No. 128 ( EITF No. 03-06 ). EITF No. 03-06 provides guidance regarding the computation of earnings per share by companies that have issued securities other than common shares that entitle the holder to participate in dividends and earnings of the company. EITF No. 03-06 is effective for the quarter ending December 31, 2004. Our company has adopted EITF No. 03-06 for the year ended December 31, 2004 and has retroactively applied the consensus in determining the earnings per share for prior periods.

(3) Each ADS represents two ordinary shares.

(4) Working capital represents total current assets less total current liabilities.

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The following table sets forth information regarding the noon buying rates in Renminbi and U.S. dollars for the periods indicated.

	<b>Renminbi per U.S. Dollar Noon Buying Rate</b>			
	<b>Average</b>	<b>High</b>	<b>Low</b>	<b>Period-End</b>
2000	8.2784	8.2799	8.2768	8.2774
2001	8.2770	8.2786	8.2676	8.2766
2002	8.2770	8.2800	8.2669	8.2800
2003	8.2770	8.2800	8.2272	8.2769
2004	8.2770	8.2773	8.2765	8.2765

	<b>Renminbi per U.S. Dollar Noon Buying Rate</b>	
	<b>High</b>	<b>Low</b>
November 2004	8.2765	8.2764
December 2004	8.2767	8.2765
January 2005	8.2765	8.2765
February 2005	8.2765	8.2765
March 2005	8.2765	8.2765
April 2005	8.2765	8.2765

Source: Federal Reserve Bank of New York

On May 26, 2005, the noon buying rate was RMB8.2765 to US\$1.00.

**B. CAPITALIZATION AND INDEBTEDNESS**

Not Applicable

**C. REASONS FOR THE OFFER AND USE OF PROCEEDS**

Not Applicable

**D. RISK FACTORS****Risks Relating to our Business**

*We are substantially dependent on two online games, which accounted for approximately 74.2% of our net revenues in 2004 and which may have a finite commercial lifespan.*

Prior to 2004, we depended on The Legend of Mir II, or Mir II, which is an online game we license from a third party, for substantially all of our net revenues. On October 8, 2003, we commercially launched The World of Legend, or Wool, which is an online game we developed in-house. In 2004, we derived approximately 47.4% and 26.8% of our net revenues from Mir II and Wool, respectively. While we expect these amounts to be reduced as these two games reach a more mature stage of their lifecycles, we expect to continue to derive a substantial portion of our net revenues from Mir II and Wool through at least 2005. Accordingly, any of the following could materially and adversely affect our business, financial condition and results of operations:

any reduction in the Mir II or Wool user base or any decrease in their popularity in the China market due to

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intensifying competition or other factors;

loss of our rights to operate these games;

failure to make improvements, updates or enhancements to Mir II or Wool in a timely manner; or

any lasting or prolonged server interruption due to network failures or other factors or any other adverse developments specific to Mir II or Wool.

***If we are unable to maintain the operation of the online games that we license, or to consistently license or develop additional successful online games, our business, financial condition and results of operations may be materially and adversely affected.***

We derive the majority of our net revenues from online games that we license from third parties. In 2004, we derived approximately 63.3% of our net revenues from licensed online games. If any of these licenses are terminated or not renewed at an acceptable cost, or at all, or if we are unable to obtain from the licensor of any of our licensed games the technical support necessary for the satisfactory operation of these games, our financial condition and results of operations may be materially and adversely affected.

In order to maintain our long-term profitability and financial and operational success, we must continually license or develop new online games that are attractive to our users to replace our existing online games as they reach the end of their useful economic life, which we believe is typically four to five years for successful online games, or two to three years for most other online games. Our ability to license successful online games will depend on their availability at an acceptable cost, our ability to compete effectively to attract the licensors of these games, and our ability to obtain government approvals required for licensing and operation of these games. Moreover, the success of our internally developed games will largely depend on our ability to anticipate and effectively respond to changing consumer tastes and preferences. In addition, developing games internally requires substantial initial investment prior to commercial launch of the games as well as a significant commitment of future resources. We cannot assure you that the games we develop or license will be attractive to users, will be viewed by the regulatory authorities as complying with content restrictions, will be launched as scheduled or will be able to compete with games operated by our competitors. If we are not able to consistently license or develop online games with continuing appeal to users, our future profitability and growth prospects will decline.

***Our license to operate Mir II in China is currently subject to an arbitration proceeding. If we lose in this arbitration, we may no longer be able to operate Mir II, which accounted for approximately 47.4% of our net revenues in 2004, and we may be required to pay an unspecified amount of damages.***

We initiated an arbitration in Singapore on July 3, 2003 under the auspices of the International Chamber of Commerce, or the ICC, against Actoz Soft Co., Ltd., or Actoz, and Wemade Entertainment Co., Ltd., or Wemade, which are two online game developers based in Korea. We commenced the arbitration in order to resolve certain disputes relating to our license to operate Mir II in China, or the Mir II license. We settled our disputes with Actoz pursuant to a settlement agreement and an amendment agreement entered into on August 19, 2003, and requested the discontinuation of the arbitration. The amendment agreement with Actoz, among other things, extended the Mir II license for at least two years.

Wemade has objected to our request for discontinuation of the arbitration, has filed counterclaims against us, and has filed cross-claims against Actoz. Wemade has also requested an injunction against our use of the Mir II software and payment of royalty fees and an unspecified amount of damages.

If the arbitrator determines that Wemade validly terminated the Mir II license and that the settlement agreement and the amendment agreement are not binding with respect to Wemade, or that the Mir II license has expired, we may no longer be able to operate Mir II, which accounted for approximately 47.4% of our net revenues in 2004. In addition, we may have to pay an unspecified amount of damages. Any lapse in our right to operate Mir II in China, as well as any damages we may be required to pay as a result of the arbitrator's decision, may have a material adverse effect on our business, financial condition and results of operations.

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***We may be subject to intellectual property infringement claims, which may force us to incur substantial legal expenses and, if determined adversely against us, may materially disrupt our business. In particular, we are currently subject to copyright infringement and unfair competition claims by Wemade and Actoz with respect to the Wool software, which if determined adversely against us, could cause us to stop operating Wool, which in 2004 accounted for approximately 26.8% of our net revenues.***

We cannot be certain that our online games do not or will not infringe upon patents, valid copyrights or other intellectual property rights held by third parties. We have in the past been, and may in the future be, subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. If we are found to have violated the intellectual property rights of others, we may be enjoined from using such intellectual property, and we may incur licensing fees or be forced to develop alternatives. In addition, we may incur substantial expenses in defending against these third party infringement claims, regardless of their merit. Successful infringement or licensing claims against us may result in substantial monetary liabilities, which may materially disrupt the conduct of our business.

On October 8, 2003, Wemade filed claims against us in the Beijing First Intermediate People's Court, or the Beijing Court, with respect to our operation of Wool. Wemade has alleged, among other things, that Wool copied Mir II and elements of the Legend of Mir III, or Mir III, which is another online game that Wemade developed, thereby infringing Wemade's copyrights in these games. In addition, Wemade has alleged that our operation of Wool violates the PRC Anti-Unfair Competition Law. In particular, Wemade has alleged that the Chinese name for Wool, which includes two characters from the Chinese name for Mir II, misleads users and that we previously encouraged users to switch from Mir II to Wool by permitting the transfer of game characters developed in Mir II to Wool. Wemade has requested the Beijing Court to, among other things, order us to stop our operation of Wool, and to pay its legal fees and related costs incurred in connection with this litigation. On May 24, 2004, the Beijing court informed us that Actoz had been joined as a co-plaintiff in these proceedings.

If the Beijing court determines that we have breached the Mir II or Mir III copyrights, we may no longer be able to operate Wool, which accounted for approximately 26.8% of our net revenues in 2004. We may also have to pay legal fees and related costs, which could be significant. In addition, if the Beijing court determines that we have violated the PRC Anti-Unfair Competition Law, we may be required to modify certain aspects of Wool, including its name. Any lapse in our right to operate Wool in China, or any modifications to the game itself, as a result of this litigation, may have a material adverse effect on our business, financial condition and results of operations.

***Repercussions stemming from user's offline actions related to online games may result in bad publicity or governmental response that could have a material and adverse impact on our business, financial condition and results of operations.***

Incidences of violence or theft between users over matters related to online games have been reported. The publicity of these incidences may reduce demand for our games through negative association. Furthermore, it is possible that regulators might seek to address such incidences by seeking to control features of the online game industry despite an absence of a legal cause or provocation for such incidences in the online games themselves. These outcomes could affect our market and operations and have a material adverse effect on our business, financial results and results of operations.

***We face significant competition which could reduce our market share and adversely affect our business, financial condition and results of operations.***

The online game market in China is increasingly competitive. Our results of operations to date may be a result, in part, of a first-mover advantage that may not continue to be available to us. A significant number of competitors have



entered the online game business in China and we expect more companies to do the same and a wider range of online games to be introduced to the China market. Competition from other online game operators, both based in China as well as overseas, is likely to increase in the future. Other websites, such as China-based Netease, Sina, and Sohu, as well as overseas-based Electronic Arts and NCsoft, are current, or potential future, competitors. As the online game industry in China is relatively new and constantly evolving, our current or future competitors may compete more successfully as the industry matures. In particular, any of these competitors may offer products and

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services that provide significant performance, price, creativity or other advantages over those offered by us. These products and services may weaken the market strength of our brand name and achieve greater market acceptance than ours. Furthermore, any of our current or future competitors may be acquired by, receive investments from or enter into other commercial relationships with, larger, well-established and well-financed companies and therefore obtain significantly greater financial, marketing and game licensing and development resources than we have. In addition, increased competition in the online game industry in China could make it difficult for us to retain existing users and attract new users, and could reduce the average number of hours played by our users or cause us to reduce our fee rates. If we are unable to compete effectively in the online game market in China, our business, financial condition and results of operations could be materially and adversely affected.

***We may not be able to successfully implement our growth strategies, which would materially and adversely affect our business, financial condition and results of operations.***

We are pursuing a number of growth strategies, including leveraging our user base to develop additional sources of revenues and exploring opportunities to expand into online entertainment offered over other media platforms, such as game consoles. Some of these strategies relate to new services or products for which there are no established markets in China, or relate to services or products in which we lack experience and expertise. We cannot assure you that we will be able to deliver new products or services on a commercially viable basis or in a timely manner, or at all.

In addition, we have begun to generate advertising revenue by selling banner advertising on our web pages, including the log-in web pages, the web pages that provide information on the features of our games, and on game pages. Our current online advertising business is very limited and, to date, we do not have significant experience with selling Internet-based advertising. Moreover, we would need to hire additional employees and incur costs relating to any efforts to increase our advertising revenues, which could materially and adversely affect our financial condition and operating results. We cannot assure you that we will be able to efficiently or effectively implement and grow our online advertising business, or that online advertising on our web pages will not detract from our users' experience and thereby adversely affect our brand name or our service offerings.

If we are unable to successfully implement our growth strategies, our revenue and profitability will not grow as we expect, and our competitiveness may be materially and adversely affected.

***There are risks associated with our business strategy, which contemplates growth through acquisitions and strategic investments.***

As a component of our growth strategy, we intend to continue to enhance our business development, including our game content offerings, by acquiring other businesses that complement our current online business, represent related but new lines of business that may be appropriate areas of expansion, or that we believe may benefit us in terms of user base, product or content offering. We also intend to make strategic investments in selected industry players. We are actively examining the merits, risks and feasibility of several potential transactions, and expect to actively search for additional acquisition opportunities in the future.

Such search and examination efforts and any related discussions with third parties, may or may not lead to future acquisitions and investments. Our reported financial results may be affected by any such acquisitions and/or investments, including any acquisitions or dispositions undertaken by us in anticipation of or in connection with any such acquisitions and/or investments. Our ability to grow through such acquisitions and investments will depend on the availability of suitable acquisition candidates at an acceptable cost or at all, our ability to compete effectively to attract and reach agreement with acquisition candidates or investee companies on commercially reasonable terms, the availability of financing to complete larger acquisitions or investments, as well as our ability to obtain any required governmental approvals. In addition, the benefits of an acquisition or investment transaction may take considerable

time to develop and we cannot assure you that any particular acquisition or investment will produce the intended benefits.

Furthermore, the identification and completion of these transactions may require us to expend significant management and other resources. Any such transaction may require that we expend a significant portion of our cash reserves and/or issue a substantial amount of new equity, which may adversely affect our financial condition and

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liquidity as well as result in significant dilution of shareholders' interests. The impact of dilution may restrict our ability to consummate further acquisitions. We may also incur debt and losses related to the impairment of goodwill and other intangible assets upon or following the acquisition of another business, and this could negatively impact our results of operations. For example, in connection with our acquisition of Actoz, we paid a premium to the market price for Actoz's shares in order to secure the controlling stake that we acquired. Additional risks associated with acquisitions include the following:

It may be difficult to assimilate the operations and personnel of an acquired business into our own business;

Management information and accounting systems of an acquired business must be integrated into our current systems;

Our management must devote its attention to assimilating the acquired business, which diverts attention from other business concerns;

We may enter markets in which we have limited prior experience, for example, we acquired approximately a 19.5% stake in Sina Corp., or Sina, and have publicly disclosed an intention to consider a business combination with Sina, however, we are not presently active in most of Sina's lines of business and have limited experience in most of these lines of business; and

We may lose some of our key employees or key employees of an acquired business.

***There have been historical deficiencies with our internal controls and there remain areas of our internal controls that require improvement. If we fail to maintain an effective system of internal controls, we may be unable to accurately report our financial results or prevent fraud, and investor confidence and the market price of our ADSs may be adversely impacted.***

In the course of their audit for the year ended December 31, 2004, our auditors identified reportable conditions, as that term is defined under standards established by the American Institute of Certified Public Accountants and is now adopted by the Public Company Accounting Oversight Board, in our internal controls. Some of these reportable conditions constitute material weaknesses in the design or operation of our internal controls that, in our independent auditors' judgment, could adversely affect our ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

We need to take further actions to continue to improve our internal controls. If we are unable to implement solutions to this and other weaknesses in our existing internal controls and procedures, or if we fail to maintain an effective system of internal controls in the future, we may be unable to accurately report our financial results or prevent fraud and investor confidence and the market price of our ADSs may be adversely impacted.

We are in the process of implementing changes to strengthen our internal controls. While we have taken actions to address these deficiencies and weaknesses, additional measures may be necessary and these measures, along with other measures expected to be taken to improve our internal controls, may not be sufficient to address the issues identified by us or to ensure that our internal controls are effective. For a description of these deficiencies and weaknesses, see Item 15 Evaluation of Disclosure Controls and Procedures. If deficiencies in internal controls cannot be corrected in a timely manner, our ability to record, process, summarize and report financial information within the time periods specified in the rules and forms of the Commission will be adversely affected. This failure could materially and adversely affect our business, our financial condition, and the market price of our ADSs.

In addition, we will become subject to Section 404 of the Sarbanes-Oxley Act of 2002 in the fiscal year ending December 31, 2006. We cannot be certain as to the timing of completion of our evaluation, testing and any remedial

actions or the impact of the same on our operations. If we cannot implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 in a timely manner or with adequate compliance, our independent auditors may not be able to provide a written attestation as to the effectiveness of our internal controls over financial reporting and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. As a result, there could be a negative reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur significant costs in improving our internal control system and the hiring of additional personnel. Any such action could increase our costs relative

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to our revenues, thereby reducing our operating margins and could negatively affect the market price of our ADSs.

***Unauthorized use of our intellectual property by third parties, and the expenses incurred in protecting our intellectual property rights, may adversely affect our business.***

We regard our copyrights, service marks, trademarks, trade secrets, patents and other intellectual property as critical to our success. Unauthorized use of the intellectual property used in our business, whether owned by us or licensed to us, may adversely affect our business and reputation.

We rely on trademark, patent and copyright law, trade secret protection and confidentiality agreements with our employees, customers, business partners and others to protect our intellectual property rights. Despite our precautions, it may be possible for third parties to obtain and use the intellectual property used in our business without authorization. For example, we discovered that the server-end software of Mir II was unlawfully released into the China market in September 2002. This software leak enabled unauthorized third parties to set up local server networks to operate Mir II, which we believe diverts a significant number of users of our most popular online game from us. We have incurred and may continue to incur considerable costs to remedy the software leak and protect our rights against the unauthorized server networks.

The validity, enforceability and scope of protection of intellectual property in Internet-related industries is uncertain and still evolving. In particular, the laws and enforcement procedures of the PRC and certain other countries are uncertain or do not protect intellectual property rights to the same extent as do the laws and enforcement procedures of the United States. Moreover, litigation may be necessary in the future to enforce our intellectual property rights. Future litigation could result in substantial costs and diversion of our resources, and could disrupt our business, as well as have a material adverse effect on our financial condition and results of operations.

***Undetected programming errors or defects in our games and the proliferation of cheating programs could materially and adversely affect our business, financial condition and results of operations.***

Our games may contain undetected programming errors or other defects. In addition, parties unrelated to us may develop Internet cheating programs that enable our users to acquire superior features for their game characters that they would not have otherwise. Furthermore, certain cheating programs could cause the loss of a character's superior features acquired by a user. The occurrence of undetected errors or defects in our games, and our failure to discover and disable cheating programs affecting the fairness of our game environment, could disrupt our operations, damage our reputation and detract from the game experience of our users. As a result, such errors, defects and cheating programs could materially and adversely affect our business, financial condition and results of operations.

***Unexpected network interruptions, security breaches or computer virus attacks could have a material adverse effect on our business, financial condition and results of operations.***

Any failure to maintain the satisfactory performance, reliability, security and availability of our network infrastructure may cause significant harm to our reputation and our ability to attract and maintain users. We maintain a distributed server network architecture with third party service providers hosting servers in more than sixty cities throughout China. Most of the servers handling log in, and all servers handling billing and data back-up matters for us, are hosted and maintained by third party service providers in Shanghai. We do not maintain full backup for our server network hardware. Major risks involved in such network infrastructure include:

any break-downs or system failures resulting in a sustained shutdown of all or a material portion of our servers, including failures which may be attributable to sustained power shutdowns, or efforts to gain unauthorized access to our systems causing loss or corruption of data or malfunctions of software or hardware; and

any disruption or failure in the national backbone network, which would prevent our users outside Shanghai from logging on to any of our games or other content, or playing the games, for which the servers are all located in Shanghai.

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In the past, our server network has experienced unexpected outages for several hours and occasional slower performance in a number of locations in China as a result of failures by third party service providers. Our network systems are also vulnerable to damage from fire, flood, power loss, telecommunications failures, computer virus, hackings and similar events. Any network interruption or inadequacy that causes interruptions in the availability of our games or deterioration in the quality of access to our games could reduce our users' satisfaction. In addition, any security breach caused by hacking, which involve efforts to gain unauthorized access to information or systems, or to cause intentional malfunctions or loss or corruption of data, software, hardware or other computer equipment, and the inadvertent transmission of computer viruses could have a material adverse effect on our business, financial condition and results of operations. We do not maintain insurance policies covering losses relating to our systems and we do not have business interruption insurance.

### ***Rapid technological change may limit our ability to recover game development costs.***

The online game industry is subject to rapid technological change. We need to anticipate the emergence of new technologies, games and platforms, and assess their market acceptance. New technologies in online game programming or operations could render Wool, The Sign, The Age or the online games that we are developing or expect to develop in the future obsolete or unattractive to users, thereby limiting our ability to recover development costs and potentially adversely affecting our future profitability and growth prospects.

### ***Any failure to maintain a stable and efficient distribution and payment network could have a material and adverse impact on our business, financial condition and results of operations.***

Online payment systems in China are in a developmental stage and are not as widely available or acceptable to consumers in China as in the United States. As a result, we rely heavily on a multi-layer distribution and payment network composed of third party distributors for our sales to, and collection of payment from, our users. As we do not employ long-term agreements with any of our distributors, we cannot assure you that we will continue to maintain favorable relationships with them. If we fail to maintain a stable and efficient distribution and payment network, our business, financial condition and results of operations could be materially and adversely affected.

### ***The limited use of personal computers in China and the relatively high cost of Internet access with respect to per capita gross domestic product may limit the development of the Internet in China and impede our growth.***

Although the use of personal computers in China has increased in recent years, the penetration rate for personal computers in China is much lower than in the United States. In addition, despite a decrease in the cost of Internet access in China due to a decrease in the cost of personal computers and the introduction and expansion of broadband access, the cost of personal Internet access, in contrast with Internet access through Internet cafes, remains relatively high in comparison to the average per capita income in China. While we have been exploring the use of other delivery platforms for our interactive entertainment business, we cannot assure you that these will be successful. The limited use of personal computers in China and the relatively high cost of personal Internet access may limit the growth of our business. Furthermore, any Internet access or