

OFFICE DEPOT INC  
Form 10-Q  
October 25, 2011  
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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

(Mark One)

Quarterly Report Pursuant to Section 13 or 15 (d) of the  
Securities Exchange Act of 1934

For the quarterly period ended September 24, 2011

or

Transition Report Pursuant to Section 13 or 15 (d) of the  
Securities Exchange Act of 1934

For the transition period from to

Commission file number 1-10948

**Office Depot, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**59-2661354**  
(I.R.S. Employer  
Identification No.)

**6600 North Military Trail; Boca Raton, Florida**  
(Address of principal executive offices)

**33496**  
(Zip Code)  
**(561) 438-4800**

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.:

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>

(Do not check if a smaller reporting company)

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

The number of shares outstanding of the registrant's common stock, as of the latest practicable date: At September 24, 2011 there were 280,467,693 outstanding shares of Office Depot, Inc. Common Stock, \$0.01 par value.

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	September 24, 2011	December 25, 2010	September 25, 2010
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	\$ 452,652	\$ 627,478	\$ 678,717
Receivables, net	918,580	963,787	987,013
Inventories	1,124,013	1,233,657	1,183,854
Prepaid expenses and other current assets	165,620	203,020	163,119
<b>Total current assets</b>	<b>2,660,865</b>	<b>3,027,942</b>	<b>3,012,703</b>
Property and equipment, net	1,081,905	1,157,013	1,219,151
Goodwill	61,608	19,431	19,431
Other intangible assets	36,752	21,840	22,634
Deferred income taxes	37,913	33,319	81,395
Other assets	291,448	309,892	313,628
<b>Total assets</b>	<b>\$ 4,170,491</b>	<b>\$ 4,569,437</b>	<b>\$ 4,668,942</b>
<b>Liabilities and stockholders' equity</b>			
Current liabilities:			
Trade accounts payable	\$ 877,090	\$ 1,080,276	\$ 1,045,121
Accrued expenses and other current liabilities	1,039,776	1,188,233	1,170,788
Income taxes payable	4,052	2,568	6,653
Short-term borrowings and current maturities of long-term debt	35,253	72,368	73,475
<b>Total current liabilities</b>	<b>1,956,171</b>	<b>2,343,445</b>	<b>2,296,037</b>
Deferred income taxes and other long-term liabilities	464,586	514,218	582,081
Long-term debt, net of current maturities	647,674	659,820	657,164
<b>Total liabilities</b>	<b>3,068,431</b>	<b>3,517,483</b>	<b>3,535,282</b>
Commitments and contingencies			
Redeemable preferred stock, net (liquidation preference \$368,516 in 2011 and 2010)	355,979	355,979	355,979
Stockholders' equity:			
Office Depot, Inc. stockholders' equity:			
Common stock — authorized 800,000,000 shares of \$.01 par value; issued and outstanding shares — 286,382,961 in 2011, 283,059,236 in December 2010 and 282,982,123 in September 2010	2,864	2,831	2,830
Additional paid-in capital	1,143,938	1,161,409	1,164,525

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Accumulated other comprehensive income	216,273	223,807	205,761
Accumulated deficit	(559,474)	(634,818)	(535,407)
Treasury stock, at cost 5,915,268 shares in 2011 and 2010	(57,733)	(57,733)	(57,733)
<b>Total Office Depot, Inc. stockholders' equity</b>	<b>745,868</b>	<b>695,496</b>	<b>779,976</b>
Noncontrolling interest	213	479	(2,295)
<b>Total stockholders' equity</b>	<b>746,081</b>	<b>695,975</b>	<b>777,681</b>
Total liabilities and stockholders' equity	\$ 4,170,491	\$ 4,569,437	\$ 4,668,942

*This report should be read in conjunction with the Notes to Condensed Consolidated Financial Statements ( Notes ) herein and the Notes to Consolidated Financial Statements in the Office Depot, Inc. Form 10-K filed February 22, 2011, as amended on April 6, 2011 (the 2010 Form 10-K/A ).*

**Table of Contents****OFFICE DEPOT, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)****(Unaudited)**

	13 Weeks Ended		39 Weeks Ended	
	September 24, 2011	September 25, 2010	September 24, 2011	September 25, 2010
Sales	\$ 2,836,737	\$ 2,899,717	\$ 8,519,838	\$ 8,671,162
Cost of goods sold and occupancy costs	1,981,717	2,070,534	5,992,578	6,161,560
Gross profit	855,020	829,183	2,527,260	2,509,602
Store and warehouse operating and selling expenses	672,621	665,905	2,013,170	1,998,339
General and administrative expenses	163,282	154,965	492,608	475,043
Operating profit	19,117	8,313	21,482	36,220
Other income (expense):				
Interest income	317	2,513	1,158	3,493
Interest expense	17,306	(6,093)	(19,512)	(40,456)
Miscellaneous income, net	5,536	11,189	19,869	21,969
Earnings before income taxes	42,276	15,922	22,997	21,226
Income tax benefit	(58,573)	(24,700)	(52,346)	(32,496)
Net earnings	100,849	40,622	75,343	53,722
Less: Net loss attributable to the noncontrolling interest	(23)	(632)	(1)	(1,066)
Net earnings attributable to Office Depot, Inc.	100,872	41,254	75,344	54,788
Preferred stock dividends	9,213	9,210	27,639	27,898
Net earnings available to common shareholders	\$ 91,659	\$ 32,044	\$ 47,705	\$ 26,890
Earnings per share:				
Basic	\$ 0.29	\$ 0.12	\$ 0.17	\$ 0.10
Diluted	0.28	0.12	0.17	0.10

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### Weighted average number of common shares outstanding:

Basic	278,559	275,956	277,627	275,170
Diluted	357,036	275,956	277,627	275,170

*This report should be read in conjunction with the Notes herein and the Notes to Consolidated Financial Statements in the 2010 Form 10-K/A.*

**Table of Contents****OFFICE DEPOT, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>39 Weeks Ended</b>	
	<b>September 24, 2011</b>	<b>September 25, 2010</b>
<b>Cash flows from operating activities:</b>		
Net earnings	\$ 75,343	\$ 53,722
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	157,761	155,681
Charges for losses on inventories and receivables	42,834	42,784
Changes in working capital and other	(255,945)	(70,301)
<b>Net cash provided by operating activities</b>	<b>19,993</b>	<b>181,886</b>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(89,143)	(120,469)
Acquisition, net of cash acquired	(72,667)	(10,952)
Release of restricted cash	46,509	
Proceeds from assets sold and other	7,891	25,824
<b>Net cash used in investing activities</b>	<b>(107,410)</b>	<b>(105,597)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of stock options	784	2,226
Acquisition of noncontrolling interests	(1,262)	(21,786)
Share transactions under employee related plans	(695)	(1,281)
Preferred stock dividends	(27,639)	(18,688)
Debt related fees	(9,945)	(4,688)
Net proceeds (payments) on long- and short-term borrowings	(58,583)	(2,669)
<b>Net cash used in financing activities</b>	<b>(97,340)</b>	<b>(46,886)</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>9,931</b>	<b>(10,584)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(174,826)</b>	<b>18,819</b>
Cash and cash equivalents at beginning of period	627,478	659,898
<b>Cash and cash equivalents at end of period</b>	<b>\$ 452,652</b>	<b>\$ 678,717</b>

*This report should be read in conjunction with the Notes herein and the Notes to Consolidated Financial Statements in the 2010 Form 10-K/A.*





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**OFFICE DEPOT, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note A Summary of Significant Accounting Policies**

**Basis of Presentation:** Office Depot, Inc., including consolidated subsidiaries, ( Office Depot ) is a global supplier of office products and services. Fiscal years are based on a 52- or 53-week period ending on the last Saturday in December. Fiscal year 2011 is a 53-week year, with the fourth quarter including 14 weeks of operations. The Condensed Consolidated Balance Sheet at December 25, 2010 has been derived from audited financial statements at that date. The condensed consolidated interim financial statements as of September 24, 2011 and September 25, 2010, and for the 13-week and 39-week periods ended September 24, 2011 (also referred to as the third quarter of 2011 and the year-to-date 2011 ) and September 25, 2010 (also referred to as the third quarter of 2010 and the year-to-date 2010 ) are unaudited. However, in our opinion, these financial statements reflect adjustments (consisting only of normal, recurring items) necessary to provide a fair presentation of our financial position, results of operations and cash flows for the periods presented. We have included the balance sheet from September 25, 2010 to assist in analyzing our company. The balance of short-term deferred income taxes in the September 25, 2010 balance sheet has been combined with prepaid expenses and other current assets to conform to presentations used at December 25, 2010 and September 24, 2011. Additionally, the valuation allowance and non-cash tax settlements and changes in working capital and other line items in the operating activities section, and proceeds from assets sold and other line items in the investing activities section, have been combined in the condensed consolidated statement of cash flows for the 39-week period ended September 25, 2010 to conform to the year-to-date 2011 presentation.

These interim results are not necessarily indicative of the results that should be expected for the full year. For a better understanding of Office Depot and its condensed consolidated financial statements, we recommend reading these condensed interim financial statements in conjunction with the audited financial statements which are included in our Annual Report on Form 10-K for the year ended December 25, 2010, as amended (the 2010 Form 10-K/A ), filed on April 6, 2011 with the U.S. Securities and Exchange Commission ( SEC ).

**Cash Management:** Our cash management process generally utilizes zero balance accounts which provide for the reimbursement of the related disbursement accounts on a daily basis. Accounts payable and accrued expenses as of September 24, 2011, December 25, 2010 and September 25, 2010 included \$45 million, \$64 million and \$54 million, respectively, of disbursements not yet presented for payment drawn in excess of our book deposit balances, after considering offset provisions. We may borrow to meet working capital and other needs throughout any given quarter, which may result in higher levels of borrowings and invested cash within the period. At the end of the quarter, excess cash may be used to minimize borrowings outstanding at the balance sheet date.

**New Accounting Pronouncements:** Effective for the first quarter of 2012, a new accounting standard will require the presentation of net income and other comprehensive income either as a continuous statement or as two separate statements. In past periods, we have presented the components of other comprehensive income as a separate statement for the full year and as a separate footnote for interim periods. We have not yet decided on the format that will be used in future periods. The standard will not change the recognition or measurement of net income or other comprehensive income.

In September 2011, the Financial Accounting Standards Board issued new guidance on testing goodwill for impairment. Entities will have an option of performing a qualitative assessment before calculating the fair value of their reporting units. If, based on the qualitative assessment, an entity concludes it is more likely than not that the fair value of the reporting unit exceeds its carrying value, quantitative testing for impairment is not necessary. The new accounting standard is applicable for goodwill impairment testing performed in years beginning after December 15, 2011 and early adoption is permitted.

There are no recently issued accounting standards that are expected to have a material effect on our financial condition, results of operations or cash flows.

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The company has been adversely affected by the downturn in the global economy in recent years and has taken actions to adapt to the changing and increasingly competitive conditions including closing stores and distribution centers ( DCs ), consolidating functional activities and disposing of businesses and assets. Exit costs related to these activities recognized during the year-to-date 2011 totaled approximately \$25 million. Of this amount, approximately \$17 million is included in Store and warehouse operating and selling expenses and approximately \$8 million is included in General and administrative expenses on the Condensed Consolidated Statement of Operations.

Exit cost accruals related to prior and current actions are as follows:

<i>(Dollars in millions)</i>	Balance at December 25, 2010	Charges Incurred	Cash Payments	Currency and Other Adjustments	Balance at September 24, 2011
Termination benefits	\$ 4	\$ 13	\$ (12)	\$ 5	\$ 5
Lease, contract, and other costs	113	22	(42)	5	98
<b>Total</b>	<b>\$ 117</b>	<b>\$ 35</b>	<b>\$ (54)</b>	<b>\$ 5</b>	<b>\$ 103</b>

The charges of \$35 million recognized during the year-to-date 2011 include approximately \$10 million of accretion, adjustments and settlements of lease obligations from facilities closed in prior years.

**Note C Stockholders Equity and Comprehensive Income**

The following table reflects the changes in stockholders equity attributable to both Office Depot and our noncontrolling subsidiary interests.

<i>(In thousands)</i>	Attributable to Office Depot, Inc.	Attributable to noncontrolling interest	Total
Stockholders equity at December 25, 2010	\$ 695,496	\$ 479	\$ 695,975
Comprehensive income:			
Net earnings (loss)	75,344	(1)	75,343
Other comprehensive income (loss)	(7,534)	14	(7,520)
Comprehensive income	67,810	13	67,823
Capital transactions with noncontrolling interests	(983)	(279)	(1,262)
Preferred stock dividends	(27,639)		(27,639)
Share transactions under employee related plans	63		63
Amortization of long-term incentive stock grants	11,121		11,121
Stockholders equity at September 24, 2011	\$ 745,868	\$ 213	\$ 746,081
Stockholders equity at December 26, 2009	\$ 786,415	\$ 2,827	\$ 789,242
Comprehensive income:			
Net earnings (loss)	54,788	(1,066)	53,722

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Other comprehensive income (loss):	(32,619)	337	(32,282)
Comprehensive income (loss)	22,169	(729)	21,440
Capital contributions from noncontrolling interest	(16,066)	(4,393)	(20,459)
Preferred stock dividends	(27,898)		(27,898)
Share transactions under employee related plans	945		945
Amortization of long-term incentive stock grants	14,411		14,411
Stockholders' equity at September 25, 2010	\$ 779,976	\$ (2,295)	\$ 777,681

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Comprehensive income includes all non-owner changes in stockholders' equity and consists of the following:

<i>(In thousands)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net earnings	\$ 100,849	\$ 40,622	\$ 75,343	\$ 53,722
Other comprehensive income (loss), net of tax where applicable:				
Foreign currency translation adjustments	(50,455)	51,323	(7,176)	(34,746)
Amortization of gain on cash flow hedge	(415)	(415)	(1,244)	(1,244)
Change in deferred pension	(179)	(644)	2	3,970
Change in deferred cash flow hedge	581	1,293	898	(16)
Other		(249)		(246)
Total other comprehensive income (loss), net of tax, where applicable	(50,468)	51,308	(7,520)	(32,282)
Comprehensive income (loss)	50,381	91,930	67,823	21,440
Comprehensive income (loss) attributable to the noncontrolling interest	(41)	64	13	(729)
Comprehensive income attributable to Office Depot, Inc.	\$ 50,422	\$ 91,866	\$ 67,810	\$ 22,169

**Note D Earnings Per Share**

The following table represents the calculation of net earnings per common share:

<i>(In thousands, except per share amounts)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
<b>Basic Earnings Per Share</b>				
Numerator:				
Net earnings available to common shareholders	\$ 91,659	\$ 32,044	\$ 47,705	\$ 26,890
Assumed distribution to participating securities	(11,892)			
Assumed undistributed earnings available to common stock	79,767	32,044	47,705	26,890
Denominator:				
Weighted-average shares outstanding	278,559	275,956	277,627	275,170
Basic earnings per share	\$ 0.29	\$ 0.12	\$ 0.17	\$ 0.10
<b>Diluted Earnings Per Share</b>				
Numerator:				
Net earnings attributable to Office Depot, Inc.	\$ 100,872	\$ 41,254	\$ 75,344	\$ 54,788
Denominator:				
Weighted-average shares outstanding	278,559	275,956	277,627	275,170
Effect of dilutive securities:				
Stock options and restricted stock	4,774	6,129	5,583	6,961
Redeemable preferred stock	73,703	73,703	73,703	73,667

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Diluted weighted-average shares outstanding	357,036	355,788	356,913	355,798
Diluted earnings per share	\$ 0.28	N/A	N/A	N/A

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Following the company's issuance of the redeemable preferred stock, basic earnings per share is computed after consideration of preferred stock dividends. Shares of the redeemable preferred stock have equal dividend participation rights with common stock. The company has never paid a dividend on common stock, but the participation provisions require application of the two-class method of computing earnings per share, unless that method is antidilutive. The first step in the Basic EPS calculation assumes distribution of earnings after preferred stock to all securities, based on their contractual rights. Because the redeemable preferred stock participates equally with common shares, without duplication, the calculation assumes proportional distribution to all securities. For the third quarter of 2011, Basic EPS for common shares is \$0.29, all undistributed. Basic EPS for the redeemable preferred shares is also \$0.29, composed of \$0.13 distributed and \$0.16 undistributed. The two-class method of calculating EPS is antidilutive in all other periods presented.

The diluted EPS calculation under the two-class method includes two tests to determine the most dilutive. These tests, and the diluted EPS calculation which includes the dilutive impact of stock options and restricted stock under the treasury stock method and redeemable preferred stock under the if-converted method, result in diluted EPS for the third quarter of 2011 of \$0.28. The diluted EPS calculation for all other periods presented was antidilutive. The share amounts have been presented for informational purposes.

The quarterly preferred stock dividends payable on April 1, 2010 through October 1, 2011 were paid in cash. Should the company pay dividends on preferred shares in-kind during future periods, the earnings per share attributable to preferred and common shareholders may be different.

Awards of options and nonvested shares representing approximately 16.0 million and 12.4 million additional shares of common stock were outstanding for the third quarter and year-to-date 2011, and 13.2 million and 13.5 million for the third quarter and year-to-date 2010, respectively, but were not included in the computation of diluted earnings per share because their effect would have been antidilutive. For purposes of calculating weighted average shares, no tax benefits have been assumed in jurisdictions with deferred tax valuation allowances.

**Note E Division Information**

Office Depot operates in three segments: North American Retail Division, North American Business Solutions Division, and International Division. The following is a summary of our significant accounts and balances by segment (or Division), reconciled to consolidated totals.

<i>(In thousands)</i>	<b>Sales</b>			
	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
North American Retail Division	\$ 1,232,692	\$ 1,280,081	\$ 3,633,384	\$ 3,728,520
North American Business Solutions Division	820,864	841,824	2,430,431	2,492,678
International Division	783,181	777,812	2,456,023	2,449,964
Total	\$ 2,836,737	\$ 2,899,717	\$ 8,519,838	\$ 8,671,162

<i>(In thousands)</i>	<b>Division Operating Profit</b>			
	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
North American Retail Division	\$ 41,904	\$ 29,662	\$ 102,363	\$ 111,288
North American Business Solutions Division	39,145	25,073	100,370	59,328
International Division	19,460	29,670	59,862	90,171
Total	\$ 100,509	\$ 84,405	\$ 262,595	\$ 260,787

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A reconciliation of the measure of Division operating profit to consolidated earnings before income taxes is as follows:

<i>(In thousands)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Total Division operating profit	\$ 100,509	\$ 84,405	\$ 262,595	\$ 260,787
Unallocated general and administrative expenses	(77,309)	(74,580)	(229,874)	(223,517)
Unallocated corporate expenses	(4,083)	(1,512)	(11,239)	(1,050)
Interest income	317	2,513	1,158	3,493
Interest expense	17,306	(6,093)	(19,512)	(40,456)
Miscellaneous income, net	5,536	11,189	19,869	21,969
<b>Earnings before income taxes</b>	<b>\$ 42,276</b>	<b>\$ 15,922</b>	<b>\$ 22,997</b>	<b>\$ 21,226</b>

During the first quarter of 2011, the company acquired Svanströms Gruppen (Frans Svanströms & Co AB), an entity that sells office supplies and services in Sweden. The operations and assets of this entity have been included in the International Division since acquisition. See Note L.

Our Condensed Consolidated Balance Sheet as of September 24, 2011 reflects a goodwill balance of approximately \$61.6 million, and on each of December 25, 2010 and September 25, 2010, a balance of approximately \$19.4 million. The gross amount of goodwill and the amount of accumulated impairment losses as of September 24, 2011 are provided in the following table:

<i>(Dollars in thousands)</i>	<b>North American Retail Division</b>	<b>North American Business Solutions Division</b>	<b>International Division</b>	<b>Total</b>
Balance as of December 26, 2009				
Goodwill	\$ 1,842	\$ 367,790	\$ 863,134	\$ 1,232,766
Accumulated impairment losses	(1,842)	(348,359)	(863,134)	(1,213,335)
Balance as of December 25, 2010		19,431		19,431
2011 Changes:				
Goodwill acquired during the year			45,805	45,805
Foreign currency exchange rate changes			(3,628)	(3,628)
Balance as of September 24, 2011	\$	\$ 19,431	\$ 42,177	\$ 61,608

The company's accounting policy is to test for goodwill impairment during the fourth quarter each year but, should events occur or circumstances change, that more likely than not would reduce a reporting unit's fair value below its carrying value, that test would be accelerated. No substantive indicators have been identified through the end of the third quarter of 2011 that would change the timing of our annual impairment test.

**Note F Employee Benefit Plans****Pension Disclosures**

The components of net periodic pension cost for our foreign pension plan are as follows:



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<i>(In millions)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Service cost	\$	\$	\$	\$
Interest cost	2.5	2.7	7.4	7.8
Expected return on plan assets	(2.4)	(2.1)	(7.1)	(5.9)
Net periodic pension cost (gain)	\$ 0.1	\$ 0.6	\$ 0.3	\$ 1.9

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The pension plan was part of an entity acquired in 2003. The plan was curtailed and frozen in 2008 and no future service cost will be recognized. The original Sale and Purchase Agreement ( SPA ) included a provision whereby the seller is required to pay to the company an amount of unfunded benefit obligation as measured based on certain 2008 data. The calculation was completed by the plan's actuary, but the amount was disputed by the seller. Under the SPA, any dispute on this matter that could not be resolved between the parties would progress to arbitration, which would be a final ruling. On March 7, 2011, the arbitration tribunal issued its final decision, declaring, among other things, that the seller must pay the company approximately GBP 42.2 million (\$65.3 million at September 24, 2011 exchange rates) plus interest at EURIBOR plus 50 basis points accruing from January 31, 2009 until paid. The seller is seeking annulment of the tribunal's findings in the French courts and the company is seeking to enforce the award. The timing of resolution of this matter cannot currently be estimated.

The company will account for the award when received. The amount received, adjusted for any related assets, liabilities or expenses, will result in a credit to the consolidated statement of operations. Funds collected will be contributed to the pension plan, reducing or eliminating its unfunded position. This settlement and contribution will be addressed with the plan trustees in determining future funding requirements.

**Note G Income Taxes**

The effective tax rate for the third quarter and year-to-date 2011 was -139% and -228%, respectively, compared to -155% and -153% for the same periods of 2010. The rates for all periods presented reflect settlement of uncertain tax positions ( UTPs ). The 2011 rates include the reversal of \$66 million of UTP accruals following closure of certain tax audits and the expiration of the statute of limitations on previously open tax years. The 2010 effective rates include tax benefits from the settlement of UTPs and filing adjustments of approximately \$33 million for the third quarter and year-to-date periods. In addition, the year-to-date 2010 period included approximately \$13 million of discrete benefits from the release of a valuation allowance in Europe because of improved performance in that jurisdiction.

The aggregate settlement of UTPs in the third quarter of 2010 was reduced by approximately \$7 million which was offset against other tax-related accounts and had no impact on earnings. The tax settlements also resulted in a reversal of previously accrued interest expense of \$32 million in 2011 and \$11 million in 2010, as well as recognition of \$2 million of interest income in 2010. Our accounting policy is to include accrued interest on UTPs, and any related reversals, as a component of interest expense in the condensed consolidated statement of operations. The reversal in 2011 resulted in interest expense for the third quarter of 2011 being negative.

Following the recognition of significant valuation allowances in 2009, we have regularly experienced substantial volatility in our effective tax rate for interim periods. Because deferred income tax benefits cannot be recognized in several jurisdictions, changes in the amount, mix and timing of projected pre-tax earnings in tax paying jurisdictions can have a significant impact on the annual expected tax rate ( AETR ) which, applied against year-to-date results, can result in significant volatility in the overall effective tax rate. This interim volatility is likely to continue in future periods until the valuation allowances can be released.

We file a U.S. federal income tax return and other income tax returns in various states and foreign jurisdictions. With few exceptions, we are no longer subject to active U.S. federal, state or local income tax examinations for years before 2009. The U.S. federal tax returns for 2009, 2010 and 2011 are under review. Significant international tax jurisdictions include the U.K., the Netherlands, France and Germany. Generally, we are subject to routine examination for years 2006 and forward in these foreign jurisdictions. It is reasonably possible that some audits will close within the next twelve months which could result in a decrease of as much as \$18 million or an increase of as much as \$7 million to our accrued uncertain tax positions.

As part of the ongoing 2009 audit, the U.S. Internal Revenue Service ( IRS ) has proposed a deemed royalty assessment from our foreign operations with a tax and penalty amount of approximately \$30 million. The company disagrees with this assessment and, based on the technical merits of this issue, believes that no accrual

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is required at this time. Also, no amounts are included for this assessment in the disclosure above of reasonably possible changes within the next twelve months to our accrued uncertain tax positions. The company is working with its outside tax advisors and the IRS to resolve this dispute in a timely manner. The company may receive similar proposed assessments for subsequent fiscal years until this matter is resolved. Separately, the company has filed with the IRS for reconsideration of some or all of the 2010 denied carryback claim. We cannot estimate the outcome of this request.

**Note H Fair Value Measurements**

The company applies authoritative accounting guidance for fair value measurements of financial and nonfinancial assets and liabilities. This guidance defines fair value as 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. The related rules provide the following hierarchy for measuring fair value:

- Level 1: Quoted prices in active markets for identical assets or liabilities.
- Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.
- Level 3: Significant unobservable inputs that are not corroborated by market data. Generally, these fair value measures are model-based valuation techniques such as discounted cash flows or option pricing models using our own estimates and assumptions or those expected to be used by market participants.

Foreign currency contracts are valued at amounts receivable or payable to terminate the agreements at the reporting date and are based on observable market data for similar assets and liabilities. The carrying amounts of trade and other accounts receivable, trade and other accounts payable and other accrued expenses approximate fair value because of the short maturity of those instruments.

Fair value estimates may be required to measure certain assets and liabilities on a nonrecurring basis for asset impairments and exit cost valuations.

The following table summarizes the company's financial assets and liabilities measured at fair value on a recurring basis:

(In thousands)

	Level 2 Fair Value Measurement Category		
	September 24, 2011	December 25, 2010	September 25, 2010
<b>Assets</b>			
Commodity contracts - fuel	\$ 725	\$ 253	\$
Foreign exchange contracts	952		
<b>Liabilities:</b>			
Foreign exchange contracts	\$ 38	\$ 434	\$ 304

The company records its senior notes payable at par value, adjusted for amortization of a fair value hedge which was cancelled in 2005. The fair value of the senior notes indicated in the following table was determined based on quoted market prices.

(In thousands)

	September 24, 2011		December 25, 2010		September 25, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value	Carrying Value	Fair Value
\$400 million senior notes	\$ 399,998	\$ 388,000	\$ 400,067	\$ 398,000	\$ 400,093	\$ 393,480

The company regularly assesses the performance of each retail store against historic patterns and projections of future profitability for evidence of possible asset impairment. For the retail business, these projections are based on management's estimates of store-level sales, gross margins, direct expenses and resulting cash flows and, by their nature, include judgments about how current initiatives will impact future performance. If the anticipated cash flows of a store cannot support the carrying value of its assets, the projected cash flows are discounted to develop a Level 3 estimate of fair value. An impairment loss is recognized for the amount an individual store's carrying value exceeds its fair value. During the third quarter of 2011 and 2010, impairment charges of \$4.5 million and \$2.3 million, respectively, were recognized in the North American Retail Division. An additional \$0.7 million was recognized in the first quarter of 2011.



**Table of Contents****Note I Derivative Instruments and Hedging Activity**

As a global supplier of office products and services we are exposed to risks associated with changes in foreign currency exchange rates, commodity prices and interest rates. Our foreign operations are typically, but not exclusively, conducted in the currency of the local environment. We are exposed to the risk of foreign currency exchange rate changes when we make purchases, sell products, or arrange financings that are denominated in a currency different from the entity's functional currency. Depending on the settlement timeframe and other factors, we may enter into foreign currency derivative transactions to mitigate those risks. We may designate and account for such qualifying arrangements as hedges. Gains and losses on these cash flow hedging transactions are deferred in other comprehensive income ( OCI ) and recognized in earnings in the same period as the hedged item. Transactions that are not designated as cash flow hedges are marked to market at each period with changes in value included in earnings. Historically, we have not entered into transactions to hedge our net investment in foreign operations but may in future periods.

We also are exposed to the risk of changing fuel prices from inbound and outbound transportation arrangements. The structure of many of these transportation arrangements, however, precludes applying hedge accounting. In those circumstances, we may enter into derivative transactions to offset the risk of commodity price changes, and the value of the derivative contract is marked to market at each reporting period with changes recognized in earnings. To the extent fuel arrangements qualify for hedge accounting, gains and losses are deferred in OCI until such time as the hedged item impacts earnings. At the end of the third quarter of 2011, the company had contracts for approximately 3.1 million gallons of fuel that will be settled monthly through December 2011. Those contracts were not designated as hedging instruments.

Interest rate changes on our obligations may result from external market factors, as well as changes in our credit rating. We manage our exposure to interest rate risks at the corporate level. Interest rate sensitive assets and liabilities are monitored and assessed for market risk. Currently, no interest rate related derivative arrangements are in place. OCI includes the deferred gain from a hedge contract terminated in a prior period. This deferral is being amortized to interest expense through 2013.

Our risk management policies allow the use of specified financial instruments for hedging purposes only; speculation is not permitted.

The following tables provide information on our hedging and derivative positions and activity.

**Fair value of derivative instruments**

<i>(Dollars in thousands)</i>	<b>Balance sheet location</b>	<b>September 24, 2011</b>	<b>December 25, 2010</b>	<b>September 25, 2010</b>
<b>Derivatives designated as hedging instruments:</b>				
Foreign exchange contracts	Other current assets	\$ 559	\$	\$
Foreign exchange contracts	Other current liabilities		317	304
<b>Derivatives not designated as hedging instruments:</b>				
Foreign exchange contracts	Other current assets	\$ 393	\$	\$
Commodity contracts - fuel	Other current assets	725	253	
Foreign exchange contracts	Other current liabilities	38	117	
<b>Total derivative assets</b>		<b>\$ 1,677</b>	<b>\$ 253</b>	<b>\$</b>
<b>Total derivative liabilities</b>		<b>\$ 38</b>	<b>\$ 434</b>	<b>\$ 304</b>

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Derivatives not designated as hedging instruments (Dollars in thousands)	00000000 Location of gain/(loss) recognized in earnings	00000000 Amount of gain/(loss) recognized in earnings			
		Third quarter		Year-to-Date	
		2011	2010	2011	2010
Foreign exchange contracts	Miscellaneous income, net	\$ (220)	\$	\$ (2,728)	\$
Commodity contracts fuel	Cost of goods sold and occupancy costs & Store and warehouse operating and selling expenses*		435		3,431
Total		\$ 215	\$	\$ 703	\$

Derivatives designated as cash flow hedges: (Dollars in thousands)	Amount of gain/(loss) recognized in OCI		Location of gain/(loss) reclassified from OCI into earnings	Amount of gain/(loss) reclassified from OCI into earnings	
	Third Quarter	Year-to-Date		Third Quarter	Year-to-Date
	2011	2011		2011	2011
Foreign exchange contracts	\$ 581	\$ 1,346	Cost of goods sold and occupancy costs	\$ 95	\$ 450
Total	\$ 581	\$ 1,346		\$ 95	\$ 450

Derivatives designated as cash flow hedges: (Dollars in thousands)	Amount of gain/(loss) recognized in OCI		Location of gain/(loss) reclassified from OCI into earnings	Amount of gain/(loss) reclassified from OCI into earnings	
	Third Quarter	Year-to-Date		Third Quarter	Year-to-Date
	2010	2010		2010	2010
Foreign exchange contracts	\$ 554	\$ (2,317)	Cost of goods sold and occupancy costs	\$ (791)	\$ (2,246)
Total	\$ 554	\$ (2,317)		\$ (791)	\$ (2,246)

\* Approximately 60% of the amounts for 2011 and 2010 are reflected in cost of goods sold and occupancy costs. The remaining 40% of the amounts are reflected in store and warehouse operating and selling expenses.

The existing hedge contracts are highly effective and the ineffective portion is considered immaterial. As of September 24, 2011, the foreign exchange contracts extend through January 2012. Losses currently deferred in OCI are expected to be recognized in earnings within the next twelve months. There were no hedging arrangements requiring collateral. However, we may be required to provide collateral on certain arrangements in the future. The fair values of our foreign currency contracts and fuel contracts are the amounts receivable or payable to terminate the agreements at the reporting date, taking into account current exchange rates. The values are based on market-based inputs or

unobservable inputs that are corroborated by market data.

**Table of Contents****Note J Investment in Unconsolidated Joint Venture**

Since 1994, we have participated in a joint venture in Mexico, Office Depot de Mexico. Because we participate equally in this business with a partner, we account for this investment using the equity method. Our proportionate share of Office Depot de Mexico's net income is presented in miscellaneous income, net in the Condensed Consolidated Statements of Operations.

The following tables provide summarized unaudited information from the balance sheets and statements of earnings for Office Depot de Mexico:

<i>(In thousands)</i>	September 24, 2011	December 25, 2010	September 25, 2010
Current assets	\$ 302,491	\$ 328,854	\$ 281,221
Non-current assets	283,925	289,200	275,398
Current liabilities	197,762	202,834	163,658
Non-current liabilities	2,890	3,667	2,412

<i>(In thousands)</i>	Third quarter		Year-to-Date	
	2011	2010	2011	2010
Sales	\$ 308,128	\$ 255,228	\$ 851,937	\$ 682,983
Gross profit	87,819	72,449	245,256	195,833
Net income	17,553	17,313	49,247	41,952

During the second quarter of 2011, we received a \$25 million cash dividend from this joint venture. The dividend is included as an operating activity in the Condensed Consolidated Statement of Cash Flows.

**Note K Commitments and Contingencies**

We are involved in litigation arising in the normal course of our business. While, from time to time, claims are asserted that make demands for a large sum of money (including, from time to time, actions which are asserted to be maintainable as class action suits), we do not believe that contingent liabilities related to these matters (including the matters discussed below), either individually or in the aggregate, will materially affect our financial position, results of our operations or cash flows.

On April 6, 2011, a putative class action lawsuit was filed against the company and certain current and former executive officers alleging violations of the Securities Exchange Act of 1934 and seeking damages, fees, costs and equitable relief. The allegations made in this lawsuit primarily relate to the company's previous financial disclosures and reports regarding the certain tax losses described below. The lawsuit was filed in the United States District Court for the Southern District of Florida captioned as *Climo v. Office Depot, Inc, Steve Odland, Michael D. Newman and Neil R. Austrian*. The Court granted a request by the Central Laborers' Pension Fund (CLPF) to appoint it as lead plaintiff in the case and the CLPF filed its amended complaint on September 6, 2011. The company's response is due in November 2011.

On June 17, 2011, a derivative lawsuit was filed against certain current and former executive officers and the company, generally alleging that the officers breached their fiduciary duties. The allegations in this lawsuit primarily relate to the company's previous financial disclosures and reports regarding the certain tax losses described below. The derivative lawsuit was filed in the United States District Court for the Southern District of Florida captioned as *Long v. Steve Odland, Michael D. Newman and Neil R. Austrian, defendants, and Office Depot, Inc., nominal defendant*. A Special Litigation Committee was appointed by the company's Board of Directors to review the allegations and the Court agreed to stay the case pending the Board's investigation.



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The allegations made in the above lawsuits primarily relate to the company's previous financial disclosures and reports regarding certain tax losses. On March 31, 2011, Office Depot announced that the Internal Revenue Service had denied the company's claim to carry back certain tax losses to prior tax years under economic stimulus-based tax legislation enacted in 2009. As a result, on April 6, 2011, the company restated its financial results to revise the accounting treatment regarding its original tax position. The periods covered by the restatement are the fiscal year ended December 25, 2010 and each of the quarters ended June 26, 2010 and September 25, 2010.

In addition, in the ordinary course of business, our sales to and transactions with government customers may be subject to investigations, audits and review by governmental authorities and regulatory agencies, with which we cooperate. Many of these investigations, audits and reviews are resolved without incident. While claims in these matters may at times assert large demands, we do not believe that contingent liabilities related to these matters, either individually or in the aggregate, will materially affect our financial position, results of our operations or cash flows. Among such matters, during the first quarter of 2011, we were notified that the United States Department of Justice (DOJ) commenced an investigation into certain pricing practices related to an expired agreement that was in place between January 2, 2006 and January 1, 2011, pursuant to which state, local and non-profit agencies could purchase office supplies. We are cooperating with the DOJ on this investigation.

**Note L Acquisition**

On February 25, 2011, the company acquired all of the shares of Svanströms Gruppen (Frans Svanströms & Co AB), a supplier of office products and services headquartered in Stockholm, Sweden to complement the company's existing business in that region. As part of this all-cash transaction, the company recognized approximately \$46 million of goodwill, primarily attributable to anticipated synergies, \$20 million of amortizing intangible assets for customer relationships and proprietary names, and \$18 million of net working capital and property and equipment. The amortizing intangible assets have a weighted average life of 6.9 years. Operations have been included in the International Division results since the date of acquisition. Supplemental pro forma information as if the entities were combined at earlier periods is not provided based on materiality considerations.

**Note M Amended and Restated Agreements**

*Debt* On March 30, 2011, the company obtained from the lending institutions participating in the previously-existing credit agreement a waiver of default following identification of the need to restate the financial statements in our original Annual Report on Form 10-K filed on February 22, 2011.

On May 25, 2011, the company entered into a \$1.0 billion Amended and Restated Credit Agreement (the Amended Credit Agreement) with a group of lenders, most of whom participated in the company's previously-existing \$1.25 billion Credit Agreement. The Amended Credit Agreement extends the maturity date to May 25, 2016, reduces the applicable borrowing spread by 50 basis points, permits the company to redeem, tender or otherwise repurchase its existing 6.25% Senior Notes subject to a \$600 million minimum liquidity requirement (defined as cash on hand plus availability under the facility) and modifies certain covenants. The covenant modifications include:

- Lowering the availability threshold that would trigger maintenance of a fixed charge coverage ratio from \$187.5 million to \$125.0 million;
- Increasing the ability of the company and its subsidiaries to make investments, loans and advances by meeting a fixed charge coverage ratio of 1.0 and reduced availability test, or a new \$500 million minimum liquidity requirement;
- Permitting the company to pay up to \$75 million in restricted payments subject to a reduced \$500 million minimum liquidity requirement;
- and
- Permitting additional restricted payments based on meeting a fixed charge coverage ratio that was reduced from 1.25 to 1.10 and reduced availability test.

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*Private Label Credit Card* On June 20, 2011, the company entered into an amended and restated merchant services agreement effective June 1, 2011 with Citibank (South Dakota) N.A., the financial institution that previously provided and administered the company's private label credit card program. The agreement extends the arrangement for five years through September 30, 2016, eliminates recourse to the company for losses, obtains portfolio rights at termination, lowers the overall fees, and modifies other terms and conditions. Additionally, the previously-established funded bad debt reserve of approximately \$6 million was retained by the financial institution, eliminating recourse to the company for losses on the existing portfolio. As a result of this amendment to eliminate current and future recourse to the company, a previously-established unfunded bad debt accrual of approximately \$8 million has been reversed during the second quarter of 2011. The reversal is included in determination of operating profit for the North American Retail Division and North American Business Solutions Division. The \$17.5 million letter of credit existing at June 25, 2011, was reduced to \$12.0 million during the quarter, and is expected to be reduced further over the remaining term of the agreement. If sales under the program fall below a specified level on a rolling 12-month period over the first two years of the amended agreement, the company would be required to make a liquidating damage payment to the financial institution, though no such payment is currently anticipated.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

#### **GENERAL**

Office Depot, Inc., together with our subsidiaries, is a global supplier of office products and services. We sell to consumers and businesses of all sizes through our three segments (or Divisions): North American Retail Division, North American Business Solutions Division, and International Division.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to provide information to assist you in better understanding and evaluating our financial condition and results of operations. We recommend that you read this MD&A in conjunction with our condensed consolidated financial statements and the notes to those statements included in Item 1 of this Quarterly Report on Form 10-Q, as well as our 2010 Annual Report on Form 10-K, as amended on April 6, 2011 (the 2010 Form 10-K/A), filed with the U.S. Securities and Exchange Commission (the SEC).

This MD&A contains significant amounts of forward-looking information. Without limitation, when we use the words believe, estimate, plan, expect, intend, anticipate, continue, may, project, probably, should, could, will and similar expressions in this Quarterly Report we are identifying forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995). Our discussion of Risk Factors, found in Item 1A of this Form 10-Q and our 2010 Form 10-K, and Forward-Looking Statements, found immediately following the MD&A in our 2010 Form 10-K/A, apply to these forward-looking statements.

#### **RESULTS OF OPERATIONS**

##### **OVERVIEW**

A summary of certain factors impacting results for the third quarter of 2011 is provided below and further discussed in the narrative that follows this overview.

Sales in the third quarter of 2011 decreased 2% compared to the third quarter of 2010. Excluding sales related to dispositions and deconsolidation in the fourth quarter of 2010 and an acquisition in the first quarter of 2011, constant currency sales in the third quarter of 2011 decreased 3% compared to the prior year.

Sales in the North American Retail Division were down 4%; comparable store sales were down 2%.

Sales in the North American Business Solutions Division were down 2%.

International Division sales increased 1% in U.S. dollars, decreased 7% in constant currencies and decreased 2%, excluding the dispositions and acquisitions.

Gross margin increased approximately 150 basis points in the third quarter of 2011 compared to the third quarter of 2010, with increases recognized in all Divisions.

Total operating expenses increased 2% for the third quarter of 2011 when compared to the third quarter of 2010. However, total operating expenses in 2011 include approximately \$6 million of restructuring-related charges and other costs intended to improve efficiency and benefit operations in future periods. Total operating expenses, adjusted for charges, foreign exchange, acquisitions and dispositions, decreased by \$1 million compared to the third quarter of 2010.

The effective tax rate for the third quarter of 2011 was negative 139% compared to negative 155% for the same period in 2010. Both periods include tax benefits from resolution of uncertain tax positions. Additionally, interest expense decreased in both quarterly periods from the reversal of accrued interest on those uncertain tax positions. The company continues to carry significant deferred tax asset valuation allowances that can cause the effective tax rate to show substantial volatility.

Diluted earnings per share was \$0.28 for the third quarter of 2011 compared to \$0.12 for the same period in 2010. Both periods included significant tax and interest benefits from the reversal of uncertain tax positions.

The full year 2011 is a 53 week reporting period. Accordingly, the fourth quarter 2011 will include 14 weeks.

**Table of Contents****DIVISION RESULTS**

The company is currently evaluating the management and reporting of several aspects of our business. Decisions reached as a result of this analysis may change the allocation of costs across businesses which could impact the historical presentation of Division operating profit. To the extent that changes are significant, prior period results will be recast to provide for a meaningful comparison across periods.

**North American Retail Division**

<i>(Dollars in millions)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Sales	\$ 1,232.7	\$ 1,280.1	\$ 3,633.4	\$ 3,728.5
% change	(4)%	(1)%	(3)%	(3)%
Division operating profit	\$ 41.9	\$ 29.7	\$ 102.4	\$ 111.3
% of sales	3.4%	2.3%	2.8%	3.0%

Third quarter sales in the North American Retail Division were \$1.2 billion, down 4% from the prior year. Comparable store sales in the 1,108 stores that have been open for more than one year decreased 2% for the third quarter of 2011. The decline in comparable sales of computers and related products, which began in the later part of the second quarter of 2011, continued during the third quarter and contributed significantly to the Division's overall comparable sales decline. Positive comparable sales were reported in supplies, back-to-school essentials, technology services and copy and print offerings. Furniture sales were essentially flat. Average order value was slightly negative and customer transaction counts declined approximately 2% compared to the same period last year. The decline in total sales for the third quarter also reflects the closing of stores in Canada during the second quarter of 2011.

The North American Retail Division reported an operating profit of approximately \$42 million in the third quarter of 2011, compared to approximately \$30 million in the same period of 2010. The increase reflects gross margin improvements from a higher sales mix of supplies and less technology products, better management of pricing and promotions, and lower property costs. These benefits were partially offset by the negative flow through effect of lower sales, as well as higher expenses incurred during the quarter to fund key initiatives.

Sales for the year-to-date 2011 period decreased 3% compared to the same period in 2010; comparable store sales were 1% lower. Sales of technology and peripheral items such as software, personal computer accessories and storage devices have been lower than the prior year each quarter of 2011. Furniture sales increased for the nine month period of 2011 while sales in the supplies category were lower, but trending sequentially positive. Sales in our Copy and Print Depot increased in all quarters of 2011 compared to the prior year. Approximately \$12 million of charges related to the closure of the 10 remaining stores in Canada during the second quarter of 2011 were included in our measure of Division operating profit. The charges primarily relate to accrued lease costs as well as severance and closure costs. The improvement in operating profit after considering these charges reflects increased gross margins from lower property costs, lower promotional activity and the shift in product sales mix. Additionally, the year-to-date 2011 period includes benefits from reducing recourse provisions and changing the terms and conditions in the Office Depot private label credit card program during the second quarter, partially offset by the flow through effect of lower sales and expenses incurred to fund growth initiatives.

At the end of the third quarter of 2011, the North American Retail Division operated 1,132 stores. We opened three stores and closed two stores during the quarter.

**Table of Contents**North American Business Solutions Division

<i>(Dollars in millions)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Sales	\$ 820.9	\$ 841.8	\$ 2,430.4	\$ 2,492.7
% change	(2)%	(4)%	(2)%	(6)%
Division operating profit	\$ 39.1	\$ 25.1	\$ 100.4	\$ 59.3
% of sales	4.8%	3.0%	4.1%	2.4%

Third quarter sales in the North American Business Solutions Division were \$821 million, a 2% decrease compared to the third quarter of 2010. Average order value was flat and transaction counts were lower. Third quarter 2011 sales in the direct channel were flat, compared to the same period in 2010, while sales in the contract channel declined 3%, consistent with the declines experienced earlier in the year from customers not retained during the January 2011 transition to our new public sector purchasing consortiums. Contract channel sales to large accounts and the Federal government increased, and sales to small-to medium-sized businesses decreased slightly. Sales of supplies, including paper and ink and toner were lower, partially offset by increases in sales in the cleaning and break room categories.

The North American Business Solutions Division reported operating profit of approximately \$39 million in the third quarter of 2011, compared to \$25 million in the same period of the prior year. This increase reflects higher gross margins, operational improvements and expense management. Initiatives put in place in prior quarters to improve the Division's overall cost structure contributed to lower distribution, advertising and payroll expenses. The Division is transitioning to an internal telephone account management process that is anticipated to provide more effective selling at lower costs in future periods.

Sales for the year-to-date 2011 period decreased 2% compared to the same period in 2010. Sales in the direct channel were down slightly and sales in the contract channel were down 3%, reflecting the same factors that impacted the third quarter sales comparison. Gross margins increased for the nine month period of 2011 compared to 2010 and operating expenses decreased. In addition to the operational improvements resulting in lower distribution, advertising and payroll expenses, the year-to-date period in 2011 includes approximately \$10 million of benefits recognized during the second quarter that may not recur in future periods. These items include the Division's portion of benefits from removing recourse provisions and changing the terms and conditions in the Office Depot private label credit card program and adjustments relating to customer incentive programs.

International Division

<i>(Dollars in millions)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Sales	\$ 783.2	\$ 777.8	\$ 2,456.0	\$ 2,450.0
% change	1%	(10)%	%	(4)%
% change in constant currency	(7)%	(3)%	(6)%	(3)%
Division operating profit	\$ 19.5	\$ 29.7	\$ 59.9	\$ 90.2
% of sales	2.5%	3.8%	2.4%	3.7%

The International Division reported third quarter sales of \$783 million, reflecting an increase of 1% in U.S. dollars and a decrease of 7% in constant currencies compared to the third quarter of 2010. Excluding the revenue impact from the fourth quarter 2010 dispositions and deconsolidation, as well as the first quarter 2011 acquisition, constant currency sales were 2% lower than the comparable period of the prior year. The contract channel sales in constant currency increased overall with growth in the U.K. and Germany being partially offset from weakness in

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sales in the public sector in other European countries. Third quarter 2011 sales in the direct channel were lower across the Division. This negative trend in direct sales will continue to be an area of focus for the company. The retail channel sales decreased, after considering sales from the Division's business in Israel that was divested in late 2010 and the first quarter 2011 acquisition in Sweden.

The International Division reported third quarter 2011 operating profit of approximately \$19 million compared to \$30 million in the same period of 2010. Included in this measure of Division operating profit is approximately \$4 million of charges related to restructuring and process improvement activities. The charges primarily relate to severance and accrued lease costs, as well as costs incurred to drive process improvements. The remaining decline in Division operating profit reflects the negative flow through impact of lower constant currency sales as well as the absence of earnings in 2011 from our business in Israel that was divested in the fourth quarter of 2010. Also, certain pricing issues experienced in one European region during the first half of 2011 have improved but are not fully corrected. Initiatives put in place earlier in the year to lower the Division's cost structure are expected to continue throughout the remainder of 2011 and additional charges associated with these activities are anticipated. Benefits from initiatives to date have been reinvested in efforts to address sales declines. These and future activities are anticipated to provide benefits in future periods.

Sales for the year-to-date 2011 period were flat in U.S. dollars but declined 6% in constant currencies compared to the same period in 2010. Excluding the revenue impacts from prior year dispositions and the current year acquisition, constant currency sales were 1% lower when compared to the same period last year. Constant currency sales in the contract channel increased for the first nine months, while sales in the direct channel decreased. Retail sales, after considering the dispositions in 2010 and the acquisition in 2011, increased slightly. Division operating profit includes restructuring and process improvement charges of \$15 million for the year-to-date 2011 period. The remaining decrease in Division operating profit reflects the negative flow through of constant currencies sales decrease, as well as paper and price increases in one European region that were not able to be timely passed on to customers and competitive pressures.

The change in exchange rates positively impacted operating profit in U.S. dollars by approximately \$1 million and \$3 million, respectively, for the third quarter and first nine months of 2011, compared to the same periods in 2010.

**CORPORATE AND OTHER***General and Administrative Expenses*

The portion of General and Administrative ( G&A ) expenses considered directly or closely related to unit activity is included in the measurement of Division operating profit. Other companies may charge more or less G&A expenses and other costs to their segments, and our results therefore may not be comparable to similarly titled measures used by other entities. Our measure of Division operating profit should not be considered as an alternative to operating income or net earnings determined in accordance with accounting principles generally accepted in the United States of America.

Total G&A increased from \$155 million in the third quarter of 2010 to \$163 million in the third quarter of 2011. A breakdown of total G&A between the portion included in Division results and the portion considered corporate expenses is provided in the following table:

<i>(In millions)</i>	<b>Third quarter</b>		<b>Year-to-Date</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Division G&A	\$ 86.0	\$ 80.4	\$ 262.7	\$ 251.5
Corporate G&A	77.3	74.6	229.9	223.5
<b>Total G&amp;A</b>	<b>\$ 163.3</b>	<b>\$ 155.0</b>	<b>\$ 492.6</b>	<b>\$ 475.0</b>

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Total G&A includes restructuring and business process improvement charges of approximately \$5 million and \$17 million for the third quarter and year-to-date 2011 periods, respectively. No similar charges were recognized in the comparable periods of 2010. Of these amounts in 2011, approximately \$2 million and \$7 million for the third quarter and year-to-date periods, respectively, were included in Corporate G&A; the remainder was included in determination of Division operating profit discussed above. After considering the charges, the year-to-date difference primarily relates to variable pay amounts in the two periods.

Corporate expenses included in store and warehouse operating and selling expenses for the third quarter and year-to-date 2011 periods were approximately \$4 million and \$11 million, respectively, compared to approximately \$2 million and \$1 million in the same periods last year. The activity primarily relates to accretion, adjustments and settlements of lease obligations from facilities closed in prior years following our strategic review. The lease accretion is expected to total \$3 million for the remainder of 2011, but net corporate amounts may be impacted by gains, losses and adjustments related to the closed properties and leases that cannot be reasonably estimated at this time.

*Other income (expense)*

Interest expense in all periods was impacted by reversal of accrued interest following settlements of uncertain tax positions. Our accounting policy is to present interest accruals and reversals on uncertain tax positions as a component of interest expense. Reversals of \$32 million in the third quarter of 2011 and \$11 million in the third quarter of 2010 reduced reported interest expense for the respective quarterly and year-to-date periods. Additionally, approximately \$2 million of interest income was recognized in the third quarter of 2010 from one of the tax settlements.

Miscellaneous income, net for all periods presented is primarily attributable to earnings from our joint venture in Mexico, Office Depot de Mexico. Following an ownership restructuring in the fourth quarter of 2010, this caption also includes equity in earnings from our joint venture in India, though those impacts are not significant. The decrease in miscellaneous income, net for the third quarter of 2011 reflects earnings from the joint venture in Mexico of approximately \$9 million in both periods, partially offset by foreign currency losses in 2011 compared to foreign currency gains in 2010 and losses in 2011 from the company's deferred compensation plan. For the year-to-date period, joint venture earnings increased by approximately \$1 million to \$22 million, partially offset by losses on foreign currency and the deferred compensation plan.

*Operating Initiatives - Benefits and Costs*

Throughout 2011, the company has been implementing various initiatives to improve performance and control costs. These initiatives have provided benefits including approximately \$40 million from pricing and promotional effectiveness, \$20 million from reduced occupancy costs, \$40 million in reductions in indirect procurement and business process improvements and \$20 million in cost reductions. To fund these initiatives, we have incurred approximately \$30 million of incremental spending, including consulting fees, and reinvested approximately \$20 million for changes in selling, merchandising and marketing, and business process improvement staffing and activities. The year-to-date decline in sales have further offset the benefits from these initiatives such that the net pre-tax benefit for the first nine months of 2011 is estimated to be \$10 million. During that period, the company also recognized approximately \$34 million of restructuring-related charges and other costs. These items, together with other benefits realized such as reducing the recourse provisions and changing the terms and conditions to the Office Depot private label credit card are reflected in the change in operating profit for year-to-date 2011 compared to the same period in 2010. These benefits, costs, and impacts from sales declines have been included above in the presentation of Division operating profit or Corporate G&A, as appropriate. Additional benefits and costs are expected in future periods.

*Income Taxes*

The effective tax rate for the third quarter and year-to-date 2011 was -139% and -228%, respectively, compared to -155% and -153% for the same periods of 2010. The rates for all periods presented reflect settlement of uncertain tax positions ( UTPs ). The 2011 rates include the reversal of \$66 million of UTP accruals following closure of certain tax audits and the expiration of the statute of limitations on previously open tax years. The 2010 effective rates include tax benefits from the settlement of UTPs and filing adjustments of approximately \$33 million for the third quarter and year-to-date periods. In addition, the year-to-

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date 2010 period included approximately \$13 million of discrete benefits from the release of a valuation allowance in Europe because of improved performance in that jurisdiction.

The aggregate settlement of UTPs in the third quarter of 2010 was reduced by approximately \$7 million which was offset against other tax-related accounts and had no impact on earnings. The tax settlements also resulted in a reversal of previously accrued interest expense of \$32 million in 2011 and \$11 million in 2010, as well as recognition of \$2 million of interest income in 2010. Our accounting policy is to include accrued interest on UTPs, and any related reversals, as a component of interest expense in the condensed consolidated statement of operations. The reversal in 2011 resulted in interest expense for the third quarter of 2011 being negative.

Following the recognition of significant valuation allowances in 2009, we have regularly experienced substantial volatility in our effective tax rate for interim periods. Because deferred income tax benefits cannot be recognized in several jurisdictions, changes in the amount, mix and timing of projected pre-tax earnings in tax paying jurisdictions can have a significant impact on the annual expected tax rate ( AETR ) which, applied against year-to-date results, can result in significant volatility in the overall effective tax rate. This interim volatility is likely to continue in future periods until the valuation allowances can be released.

We file a U.S. federal income tax return and other income tax returns in various states and foreign jurisdictions. With few exceptions, we are no longer subject to active U.S. federal, state or local income tax examinations for years before 2009. The U.S. federal tax returns for 2009, 2010 and 2011 are under review. Significant international tax jurisdictions include the U.K., the Netherlands, France and Germany. Generally, we are subject to routine examination for years 2006 and forward in these foreign jurisdictions. It is reasonably possible that some audits will close within the next twelve months which could result in a decrease of as much as \$18 million or an increase of as much as \$7 million to our accrued uncertain tax positions.

As part of the ongoing 2009 audit, the U.S. Internal Revenue Service ( IRS ) has proposed a deemed royalty assessment from our foreign operations with a tax and penalty amount of approximately \$30 million. The company disagrees with this assessment and, based on the technical merits of this issue, believes that no accrual is required at this time. Also, no amounts are included for this assessment in the disclosure above of reasonably possible changes within the next twelve months to our accrued uncertain tax positions. The company is working with its outside tax advisors and the IRS to resolved this dispute in a timely manner. The company may receive similar proposed assessments for subsequent fiscal years until this matter is resolved. Separately, the company has filed with the IRS for reconsideration of some or all of the 2010 denied carryback claim. We cannot estimate the outcome of this request.

**New Accounting Pronouncements**

Effective for the first quarter of 2012, a new accounting standard will require the presentation of net income and other comprehensive income either as a continuous statement or as two separate statements. In past periods, we have presented the components of other comprehensive income as a separate statement for the full year and as a separate footnote for interim periods. We have not yet decided on the format that will be used in future periods. The standard will not change the recognition or measurement of net income or other comprehensive income.

In September 2011, the Financial Accounting Standards Board issued new guidance on testing goodwill for impairment. Entities will have an option of performing a qualitative assessment before calculating the fair value of their reporting units. If, based on the qualitative assessment, an entity concludes it is more likely than not that the fair value of the reporting unit exceeds its carrying value, quantitative testing for impairment is not necessary. The new accounting standard is applicable for goodwill impairment testing performed in years beginning after December 15, 2011 and early adoption is permitted.

There are no recently issued accounting standards that are expected to have a material effect on our financial condition, results of operations or cash flows.



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**LIQUIDITY AND CAPITAL RESOURCES**

During the second quarter of 2011, the company entered into a \$1.0 billion amended and restated credit agreement (the Amended Credit Agreement) which reduced and extended the previous \$1.25 billion agreement to May 25, 2016. The Amended Credit Agreement reduces the applicable borrowing spread, permits the company to redeem, tender or otherwise repurchase its existing 6.25% Senior Notes, subject to a \$600 million minimum liquidity requirement, and modifies certain covenants. See Note M of the Notes to the Condensed Consolidated Financial Statements for additional information.

At September 24, 2011, we had approximately \$453 million in cash and equivalents and another \$766 million available under the Amended Credit Agreement based on the September borrowing base certificate, for a total liquidity of approximately \$1.2 billion. We consider our resources adequate to satisfy our cash needs for at least the next twelve months.

At September 24, 2011, no amounts were drawn under the Amended Credit Agreement. The maximum month end amount outstanding during the third quarter of 2011 occurred in August at approximately \$43 million. There were letters of credit outstanding under the Amended Credit Agreement at the end of the quarter totaling approximately \$105 million. An additional \$0.2 million of letters of credit were outstanding under separate agreements. Average borrowings under the Amended Credit Agreement in the third quarter of 2011 were approximately \$41 million at an average interest rate of 3.59%. The maximum monthly average in the third quarter of 2011 occurred in August at approximately \$58 million.

We also had short-term borrowings of \$15 million at September 24, 2011 under various local currency credit facilities for our international subsidiaries that had an effective interest rate at the end of the third quarter of approximately 2.49%. Both the maximum month end amount and the maximum monthly average amount occurred in July at approximately \$16 million. The majority of these short-term borrowings represent outstanding balances on uncommitted lines of credit, which do not contain financial covenants.

The company was in compliance with all applicable financial covenants at September 24, 2011. On March 30, 2011, the company obtained from the lending institutions participating in the previously-existing credit agreement a waiver of default following identification of the need to restate the financial statements in our original Annual Report on Form 10-K filed on February 22, 2011.

Dividends on the company's redeemable preferred stock are payable quarterly, and will be paid in-kind or in cash, only to the extent that the company has funds legally available for such payment and a cash dividend is declared by the company's board of directors. All dividends during 2011 have been paid in cash.

During the year-to-date 2011 period, cash provided by operating activities totaled \$20 million, compared to cash provided by operating activities of \$182 million during the same period last year. This decrease primarily reflects changes in working capital and decreased business performance. Changes in foreign currency exchange rates and opening balances related to acquisitions impact working capital and other assets and liabilities reported on the condensed consolidated balance sheets but do not impact cash flow reporting. Changes in net working capital and other components resulted in a \$256 million use of cash in 2011, compared to a \$70 million use of cash in the year-to-date 2010 period. This greater use of cash reflects less of a decrease in receivables, a greater decrease in accounts payable, accrued expenses and deferred credits, which is slightly offset by a larger decrease in inventory in 2011 compared to the same period last year. The decrease in receivables reflects collection in 2010 of certain tax related amounts from tax loss carry backs that were not available in 2011. This activity is partially offset by a \$25 million dividend received from our joint venture in Mexico, Office Depot de Mexico, in the second quarter of 2011. No dividends were received in 2010. The decrease in inventory relates to the sell through of the back to school inventory as well as initiatives to further improve lowering our inventory to more sustainable levels through better managed safety stock and minimum presentation levels. The decrease in accounts payable, accrued expenses and deferred credits is attributable to the non-cash release of federal uncertain tax positions from prior periods and the decrease in trade and non trade accounts payable. We anticipate working capital improvements for the rest of 2011. Working capital is influenced by a number of factors including the flow of goods, credit terms, timing of promotions, vendor production planning, new product introductions and working capital management. For our accounting policy on cash management, see Note A of the Notes to Condensed Consolidated Financial Statements.

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Cash used in investing activities was \$107 million in the year-to-date 2011 period, compared to a use of cash of \$106 million in the same period last year. The use of cash for the 2011 period reflects capital expenditures of approximately \$89 million and approximately \$73 million for the first quarter 2011 acquisition of an entity in Sweden, partially offset by the release of restricted cash related to the Sweden acquisition that was held in escrow at December 25, 2010. During the year-to-date 2011 period, we received approximately \$7 million of proceeds from the disposition of assets. Investing activities for the year-to-date 2010 period included capital expenditures of approximately \$120 million and an \$11 million payment to complete an acquisition, partially offset by approximately \$25 million of proceeds from the disposition of assets.

Cash used in financing activities was approximately \$97 million for the year-to-date 2011 period, compared to a use of cash of \$47 million in the same period last year. During the year-to-date period 2011, we paid cash dividends on our convertible preferred stock of approximately \$28 million. Additionally, approximately \$9 million of dividends was accrued during the third quarter of 2011 and subsequently paid on October 3, 2011. Other outflows during the year-to-date period 2011 included net payments of approximately \$59 million on short-term and long-term borrowings as well as an additional \$10 million in fees related to the Amended Credit Agreement. Financing activities in the year-to-date period 2010 included \$22 million for the acquisition of noncontrolling interests, payment of cash dividends on preferred stock of \$19 million, net payments of approximately \$3 million on short-term and long-term borrowings, as well as an additional \$5 million in fees related to the amendment of our asset based credit facility.

**CRITICAL ACCOUNTING POLICIES**

Our condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Preparation of these statements requires management to make judgments and estimates. Some accounting policies have a significant impact on amounts reported in these financial statements. A summary of significant accounting policies and a description of accounting policies that are considered critical may be found in our 2010 Form 10-K/A, filed on April 6, 2011, in Note A of the Notes to the Consolidated Financial Statements and the Critical Accounting Policies section of the Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.****Interest Rate Risks**

At September 24, 2011, there had not been a material change in the interest rate risk information disclosed in the Market Sensitive Risks and Positions subsection of the Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Item 7 of our 2010 Form 10-K/A.

**Foreign Exchange Rate Risks**

At September 24, 2011, there had not been a material change in any of the foreign exchange risk information disclosed in the Market Sensitive Risks and Positions subsection of the Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Item 7 of our 2010 Form 10-K/A.

**Item 4. Controls and Procedures.****Evaluation of disclosure controls and procedures**

We maintain controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be in this report is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Our management recognizes that any controls and procedures, no matter how well designed and operated, can only provide reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the possible controls and procedures. Each reporting period, the company carries out an evaluation, with the participation of its Chief Executive Officer (CEO), and Chief Financial Officer (CFO), of the effectiveness of the design and operation of the company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Act).



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In April 2011, the company restated certain of its historical financial results to revise the accounting treatment regarding a tax position that was denied by the Internal Revenue Service. The company had claimed to carry back certain tax losses to prior tax years under economic stimulus-based tax legislation enacted in 2009.

Based on the evaluation, the CEO and CFO concluded that, due to the existence of a material weakness in internal control over financial reporting in the area of accounting for the income tax implications of complex transactions, the company's disclosure controls and procedures were not effective as of the end of the period covered by this report.

For additional information regarding the restatements of certain of the company's historical financial results and the material weakness identified by management, see Item 9A. Controls and Procedures in the company's Amendment No. 1 to its Annual Report on Form 10-K/A for the year ended December 25, 2010, filed on April 6, 2011 with the SEC.

**Changes in Internal Control over Financial Reporting**

There has been no change in the company's internal control over financial reporting that occurred during the company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. However, as a result of the identification of the issue that led to the restatements and the related reassessment of internal control over financial reporting in early April 2011, the company has developed certain remediation steps to address the material weakness and to improve its internal control over financial reporting. Specifically, the following steps are being implemented:

- increase the level of review and validation of work performed by management and third-party tax professionals in the preparation of our provision for income taxes; and
- require the involvement of two third-party subject matter experts for material and complex tax transactions.

We are committed to a strong internal control environment, and believe that these remediation actions represent significant improvements. The company anticipates that it will complete its testing of the additional internal control processes designed to remediate this material weakness in 2011; however, additional measures may be required, which may require additional implementation time. We will continue to assess the effectiveness of our remediation efforts in connection with management's future evaluations of internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

We are involved in litigation arising in the normal course of our business. While, from time to time, claims are asserted that make demands for a large sum of money (including, from time to time, actions which are asserted to be maintainable as class action suits), we do not believe that contingent liabilities related to these matters (including the matters discussed below), either individually or in the aggregate, will materially affect our financial position, results of our operations or cash flows.

On April 6, 2011, a putative class action lawsuit was filed against the company and certain current and former executive officers alleging violations of the Securities Exchange Act of 1934 and seeking damages, fees, costs and equitable relief. The allegations made in this lawsuit primarily relate to the company's previous financial disclosures and reports regarding the certain tax losses described below. The lawsuit was filed in the United States District Court for the Southern District of Florida captioned as *Climo v. Office Depot, Inc, Steve Odland, Michael D. Newman and Neil R. Austrian*. The Court granted a request by the Central Laborers' Pension Fund (CLPF) to appoint it as lead plaintiff in the case and the CLPF filed its amended complaint on September 6, 2011. The company's response is due in November 2011.

On June 17, 2011, a derivative lawsuit was filed against certain current and former executive officers and the company, generally alleging that the officers breached their fiduciary duties. The allegations in this lawsuit primarily relate to the company's previous financial disclosures and reports regarding the certain tax losses described below. The derivative lawsuit was filed in the United States District Court for the Southern District of Florida captioned as *Long v. Steve Odland, Michael D. Newman and Neil R. Austrian, defendants, and Office Depot, Inc., nominal defendant*. A Special Litigation Committee was appointed by the company's Board of Directors to review the allegations and the Court agreed to stay the case pending the Board's investigation.

The allegations made in the above lawsuits primarily relate to the company's previous financial disclosures and reports regarding certain tax losses. On March 31, 2011, Office Depot announced that the Internal Revenue Service had denied the company's claim to carry back certain tax losses to prior tax years under economic stimulus-based tax legislation enacted in 2009. As a result, on April 6, 2011, the company restated its financial results to revise the accounting treatment regarding its original tax position. The periods covered by the restatement are the fiscal year ended December 25, 2010 and each of the quarters ended June 26, 2010 and September 25, 2010.

In addition, in the ordinary course of business, our sales to and transactions with government customers may be subject to investigations, audits and review by governmental authorities and regulatory agencies, with which we cooperate. Many of these investigations, audits and reviews are resolved without incident. While claims in these matters may at times assert large demands, we do not believe that contingent liabilities related to these matters, either individually or in the aggregate, will materially affect our financial position, results of our operations or cash flows. Among such matters, during the first quarter of 2011, we were notified that the United States Department of Justice (DOJ) commenced an investigation into certain pricing practices related to an expired agreement that was in place between January 2, 2006 and January 1, 2011, pursuant to which state, local and non-profit agencies could purchase office supplies. We are cooperating with the DOJ on this investigation.

**Item 1A. Risk Factors.**

There have been no material changes in our risk factors from those previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 25, 2010 filed on February 22, 2011.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

The company's Amended Credit Agreement allows payment of cash dividends on preferred stock and share repurchases, in an aggregate amount of \$75 million per fiscal year subject to the satisfaction of certain liquidity requirements. Also, so long as investors in the redeemable preferred stock own at least 10% of the common stock voting rights, on an as-converted basis, the affirmative vote of a majority of the shares of preferred stock then outstanding and entitled to vote is required for the declaration or payment of a dividend on common stock. The company has never declared or paid cash dividends on its common stock.

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**Item 6. Exhibits.**

Exhibits

31.1	Rule 13a-14(a)/15d-14(a) Certification of CEO
31.2	Rule 13a-14(a)/15d-14(a) Certification of CFO
32	Section 1350 Certification
(101.INS)	XBRL Instance Document
(101.SCH)	XBRL Taxonomy Extension Schema Document
(101.CAL)	XBRL Taxonomy Extension Calculation Linkbase Document
(101.DEF)	XBRL Taxonomy Extension Definition Linkbase Document
(101.LAB)	XBRL Taxonomy Extension Label Linkbase Document
(101.PRE)	XBRL Taxonomy Extension Presentation Linkbase Document

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**SIGNATURES**

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.

**OFFICE DEPOT, INC.**

(Registrant)

Date: October 25, 2011

By: /s/ Neil R. Austrian  
Neil R. Austrian  
Chief Executive Officer and

Chairman, Board of Directors  
(Principal Executive Officer)

Date: October 25, 2011

By: /s/ Michael D. Newman  
Michael D. Newman  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer)

Date: October 25, 2011

By: /s/ Mark E. Hutchens  
Mark E. Hutchens  
Senior Vice President  
  
and Controller  
(Principal Accounting Officer)

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civil servant examination, and IT training. As of December 31, 2013, we had approximately 135,000 registered teachers on our platform.

**Finance.** Users interested in finance and investment can interact with other users, including financial experts on YY channels. YY channels allow users to discuss investment-related topics, including stock market trends and investment basics.

**Literature.** Users gather on YY channels to review and conduct live discussions on literature, particularly novels. Our popular literary channels include book clubs or fan clubs for famous writers. Users on YY channels also host live events such as book promotions and meet-the-author events.

**Conference Calls.** YY channels are often used as a convenient online gathering place for a wide range of uses. YY enables small and medium business as well as large corporations to conduct conference call easily, efficiently and economically on YY channels.

*Organization and Management of Channels*

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To help our users navigate and explore the channels on YY Client, we created online catalogs grouped by topics and common interests for users to browse. Within each group, the channels are then ranked by popularity. These online catalogs are also searchable by keywords, which makes it easier for users looking to explore social groups beyond their usual channels to find and join other channels that touch upon different interest areas.

Each YY channel is set up by one user, who becomes the channel's owner. We provide management tools to each channel owner to tailor such channel to his or her own specific interests, establish housekeeping rules, manage hierarchies and manage daily operations of the channel. Channel owners are usually engaged in the active promotion of their channels, often recruiting like-minded users to help manage, monitor and maintain order within their channels.

Each of our channels can support millions of people concurrently, and to date, the largest online event we hosted attracted approximately 1.4 million peak concurrent users in a single channel. We provide three basic management modes for channel owners to organize the live voice and video-communications within their channels: "queue," "chair" and "free" modes. Typically, channel owners and managers choose the type of management mode for their channels depending on the number of users in their channels and the specific needs of these channels. In queue mode, each user can sign in to line up to speak or broadcast, and can only be heard or seen when his or her turn comes "at the mic." This queue mode is a popular mode for karaoke channels, where users take turns performing live in front of other channel users. In chair mode, only the "chair," meaning the owners or other designated persons, are allowed to speak or broadcast video; the remaining users can listen, watch and respond through typing text on the screen. This mode is often used in channels set up by online game players' guilds, as some of these guilds have thousands of users taking orders from a few leaders, who can speak and direct their team's collective actions while the users are simultaneously signed on to play certain online games. In free mode, any user in the channel can conduct effective voice- and video-enabled communications at any time; this mode is often chosen by channels with a limited number of users, since too many people talking at once would make effective communication impossible. In addition, we provide channel owners and managers with a broad range of functions to tailor the channels to suit particular needs, such as granting certain privileges to a member who makes particular contributions to the channel or banning certain channel users for inappropriate behavior.



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We work closely with channel owners and managers by considering and implementing some of their suggestions and feedback and providing them with the tools they require to manage and promote their channels. We also monitor channels for levels of user activity and periodically shut down inactive ones.

*Game Center on YY Client*

The game center on YY Client currently primarily consists of a game lobby and VIP game access. The game lobby enables users to access various online games without downloading any additional client software. The VIP game access provide our users with access to new games being developed or tested by third party game developers, and afford game developers an opportunity to promote their games among our users as well as solicit user feedback on new games.

We conduct market research regarding trends and demand for online games and various types of in-game virtual items, and often work with third party game developers to develop and offer a wide range of in-game virtual items. We intend to continue to source popular online games to users on YY Client.

*Web-based YY*

We launched an extension of YY Client, web-based YY, in October 2012. Web-based YY enables users to conduct real-time interactions on the web without requiring any downloads or installations. Web-based YY optimizes YY technology for the web, transcending the limitations of operational systems and enabling real-time communications on the web by simply clicking on a link. To date, web-based YY has established stable, quality service, and we expect it to become a lively community of web-based real-time rich communications as it develops.

*Online Portals*

YY.com is our community-driven portal site that offers visitors and users a centralized location to learn about, navigate and access the offerings on our broader platform. Through YY.com, our user community can download the latest versions of YY Client and Mobile YY applications to attend live group activities and access special-interest resources and entertainment such as online games, music and online education. YY.com offers a channel guide for users to identify channels that cater to their respective interests. YY.com enables performers to update schedules and information on upcoming live concert performances and other types of entertainment on YY channels and hosts numerous fan clubs for popular performers.

Duowan.com is a dedicated game media website that provides comprehensive information on online games and other resources for users and online game players. Duowan.com provides comprehensive gaming resources such as updated news and announcements of gaming events and the launch or release of new games, and hosts a text-based discussion forum in which users can discuss their game-playing strategies and interact socially through postings. Duowan.com was launched in 2005 and had 9.9 million, 19.1 million and 37.0 million average daily unique visitors for the months of December 2011, 2012 and 2013, respectively.

YY.com and Duowan.com both offer links to online games on YY Client.

We launched 100.com in early 2014 as a dedicated web portal to our education platform, 100 Education. Our 100 Education platform provides a variety of exam preparation classes, such as TOEFL (Test of English as a Foreign Language) and IELTS (International English Language Testing System) preparation courses, to students. We allow teachers to offer courses on our 100 Education platform freely. We will also open an online enrollment channel, providing simplified access for our users to participate in the courses.

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***Mobile Applications***

We develop mobile applications to capture a greater share of the growing number of users that access live online social platforms, internet communications and other internet services through mobile operating systems. While we continue to develop and upgrade our platform, a key focus of our research and development is on Mobile YY, a version of YY Client that can be accessed through mobile devices that we launched in September 2010. To accelerate monetization of our mobile platform, we introduced virtual item purchase functions on Mobile YY in October 2013. In addition, we do not currently intend to monetize Mobile YY by placing advertisements on Mobile YY, as we believe that advertising on Mobile YY may clutter the user interface and distract users from their in-channel activities. This restriction on advertisements may also limit Mobile YY's ability to generate revenues. See "Item 3. Key Information D. Risk Factors Risks Related to Our Business If we are unable to successfully capture and retain the growing number of users that access internet services through mobile devices or successfully monetize Mobile YY, our business, financial condition and results of operations may be materially and adversely affected."

Mobile YY contains the basic functions and services offered on our regular YY Client, which enables our users to access a large selection of content on our platform and helps them keep in touch with their friends or online guilds and social groups when they do not have convenient PC access. The live broadcasting function of Mobile YY enables our users to broadcast videos on our platform anytime and anywhere through their mobile devices. Mobile YY also provides access to mobile games operated by us.

We intend to explore more user-friendly, mobile-specific functions for our platform in the future.

**Technology**

We believe we are an industry leader in providing large-scale quality multi-user voice- and video-enabled online services in China, and we intend to continue to update our technology to maintain this leadership position.

***QoS for online multi-media communications***

Quality of Service, or QoS, assurance is a key element of any high quality delivery of voice and video data over the internet. For live voice- or video-enabled communications, any data packet loss and jitter, or delay in transmission, is often immediately noticeable to users. We devote significant resources to maintain and develop a creative combination of multiple voice- and voice-over internet protocol, or VOIP, quality assurance mechanisms to minimize data loss and jitter. The mechanisms we employ include but not limited to cloud-based intelligence routing, low-bitrate redundant solution, upstream-forward error correction and adaptive jitter. A special intelligent routing algorithm we designed automatically seeks optimal ways of delivering voice and video data across our cloud-based network, enabling us to provide better QoS even when the QoS levels are lower on certain routes.

We employ computer programs and design and implement a standardized set of measurements to help monitor our service quality. Our system periodically collects, and our team of experts analyzes, data from each of our data centers to evaluate the voice- and video-quality for each user using a systematic standard. We have set up formal procedures to handle different levels of server breakdowns and network-related emergencies, and our team can remotely discover issues and access any server to promptly resolve issues.

***Large, dedicated cloud-based network infrastructure***

Our team of experts developed a cloud-based network infrastructure specifically designed to handle multi-party voice- and video-enabled real-time online interactions. We own over 7,000 servers which are

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hosted in the data centers we lease from third parties throughout the country as of December 31, 2013. To deliver voice data, we require a limited bandwidth of approximately 2 KB per second, which is easily obtainable. Our cloud-based network infrastructure provides quality data delivery and allows multiple users to interact online from anywhere in China with ease and speed.

Our system is designed for scalability and reliability to support growth in our user base. The number of our servers contributes significantly to our fast streaming speed and reliable services, and can be expanded with comparative ease, given the low cost of renting data centers to host additional servers in any high traffic regions in our network. We believe that our current network facilities and broadband capacity provide us with sufficient capacity to carry out our current operations, and can be expanded to meet additional capacity relatively quickly. The amount of bandwidth we lease is continually expanded to reflect increased peak concurrent user numbers.

***Content management and monitoring***

YY Client, YY.com and Duowan.com all contain user-generated content, which we are required to monitor for compliance with PRC laws and regulations. A team within our data security department helps in enforcing our internal procedures to ensure that the content in our system are in compliance with applicable laws and regulations. They are aided by a program designed to periodically sweep our platform and the data being conveyed in our system for sensitive key words or questionable materials. Content that contains certain keywords are automatically filtered by our program and cannot be successfully posted on our platform. Thus we are able to minimize offending materials on our platform and to remove such materials promptly after they are discovered. See "Item 3. Key Information D. Risk Factors Risks Related to Our Business We may be held liable for information or content displayed on, retrieved from or linked to our platform, or distributed to our users, and PRC authorities may impose legal sanctions on us, including, in serious cases, suspending or revoking the licenses necessary to operate our platform."

***Accumulated experience and data for a proprietary technology platform***

Significant time and efforts are required to build and operate an infrastructure such as ours. The technological difficulties which a platform that hosts 10,000 concurrent users faces differ greatly from the difficulties a platform with 100,000 and 1,000,000 concurrent users faces, including many issues to be considered when programming for the platform and planning the infrastructure. Since our launch, we have gradually developed an effective system to identify, study and resolve issues that we encounter every day. In addition, our team members have been trained over the years to anticipate and resolve any issues, having gained significant knowledge from building and maintaining our platform over time.

***Technology team***

As of December 31, 2013, our dedicated technology team consisted of approximately 1,067 employees; the team is divided into three departments, serving (a) YY Client and cloud service, (b) online games and YY.com and (c) Duowan.com, respectively. Approximately 50 members of our technology team are dedicated to monitoring and maintaining our network infrastructure 24 hours a day, seven days a week. Our technology team checks the voice and video data quality received by various users, the quality of user experience on our platform and the proper functioning of our server equipment in our network, as well as contacting internet data center hosts to fix any issues located through such checks. Having launched and developed our video-enabled technology on an increasing number of channels, our team expects to provide full voice- and video-enabled live social interactions in the future.

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**Marketing and Sales**

*Viral and other marketing for our platform*

Historically, we have incurred minimal marketing expenses for our platform and have built a large community of users primarily through viral marketing, with word of mouth referrals and repeat user visits ultimately driven by user experience. While we have significantly benefited from the effects of powerful viral marketing, we recently initiated, and plan to continue, certain marketing activities designed to further promote our platform to a broader range of potential users.

*Advertisers on our platform*

As of December 31, 2013, we had a dedicated sales and marketing force of 48 experienced professionals; approximately half of these professionals were in charge of serving advertisers and advertising agencies. Currently, a majority of our sales effort is devoted to maintaining and expanding the level of our advertising revenues from online games, since advertising revenues from online games contributed a substantial majority of our online advertising revenue. We expect our online advertising revenues as a percentage of our total net revenues to decrease in the future as we capitalize on increased monetization opportunities for YY Client and as IVAS revenues continue to increase. The compensation for our sales personnel includes basic monthly salaries and sales commissions based on the advertising revenues that they bring in.

*Services for game developers*

We have entered into hosting agreements with a number of game developers. These agreements provide for a mutual exchange of resources between us and the game developers: we provide the communication platform for their games, and in exchange they promote our platform through their game interfaces.

**Seasonality**

Our results of operations are subject to seasonal fluctuations. However, seasonal fluctuations have not posed material operational and financial challenges to us, as such periods tend to be brief and predictable.

**Competition**

We face competition in several major aspects of our business, particularly from companies that provide online social networking, internet communication and online games. We also compete for online advertising revenues with other internet companies that sell online advertising services in China.

***Social connectivity and communications.*** In relation to voice-enabled communication tools, there are several internet voice communication service providers in China, including iSpeak, Dudu and Tencent's QQtalk, and leading international internet voice communication service providers, such as Skype, that are expanding in the China market. In addition, some other leading Chinese internet companies have announced the launch of internet voice communication services. We compete with other internet companies that provide real-time voice and video services to Chinese internet users.

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We may also face potential competition from global social networking service providers that seek to enter the China market, whether independently or through the formation of alliances with, or acquisition of, PRC domestic internet companies.

**Online game media and hosting.** We have various competitors in the online game media market in China. Duowan.com's primary competitor among game media websites is 17173.com. For game hosting, our competitors include other major internet companies that host games, such as Tencent, Qihoo 360 and other private companies.

**Research and Development**

We believe that our ability to develop internet and mobile online applications and services tailored to respond to the needs of our user base has been a key factor for the success of our business.

As of December 31, 2013, our research and development team consisted of 944 members. All of our service programs are designed and developed internally, including various interactive technologies. We expect to continue to develop all of our core technologies in-house.

We currently focus our product development efforts on various areas, including (a) the continued improvement of our audio quality and video-enabled features on our real-time interactive social platform, (b) the ongoing improvement of general user experience on our platform by providing virtual items, additional games and online game add-ons as well as certain members-only special features, and (c) the continued development of Mobile YY. We plan to further invest in our voice and video technology and in developing Mobile YY.

**Intellectual Property**

We regard our patents, trademarks, domain names, copyrights, trade secrets, proprietary technologies and similar intellectual property as critical to our success. We seek to protect our intellectual property rights through a combination of patent, trademark, copyright and trade secret protection laws in the PRC and other jurisdictions, as well as through confidentiality agreements and procedures with our employees, partners and others. The intellectual property rights we own include: (1) 6 patents relating to our proprietary technology; (2) 73 registered domain names, including YY.com, Duowan.com and Chinaduo.com; (3) registered copyrights to 70 software programs developed by us relating to various aspects of our operations, including voice software, games platform, general support and user management; and (4) 147 trademarks and service marks for our brands and logos in China, including YY and certain Chinese logos relating to Duowan and YY. As of December 31, 2013, we had filed 136 patent applications covering certain proprietary technologies and 78 trademark applications in China.

**Legal Proceedings**

We have initiated a lawsuit against Beijing Wonderad Advertisement Co., Ltd., one of our advertisement agents, in Guangzhou in February 2014, claiming for the unpaid advertisement fee and liquidated damages for late payment in the aggregate amount of approximately RMB84 million. Apart from this lawsuit, we are currently not a party to, and are not aware of any threat of, any legal, arbitration or administrative proceedings that, in the opinion of our management, are likely to have a material and adverse effect on our business, financial condition or results of operations. From time to time, we have become, and may in the future become, a party to various legal or administrative proceedings or claims arising in the ordinary course of our business. Regardless of the outcome, legal or administrative proceedings or claims may have an adverse impact on us because of defense and settlement costs, diversion of management attention and other factors.

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**PRC Regulation**

Certain areas related to the internet, such as telecommunications, internet information services, connections to the international information networks, internet information security and censorship and online game operations, are covered extensively by a number of existing laws and regulations issued by various PRC governmental authorities, including:

the Ministry of Industry and Information Technology, or the MIIT;

the Ministry of Culture, or the MOC;

the General Administration of Press and Publication, or the GAPP;

the State Administration for Radio, Film and Television, or the SARFT;

the National Copyright Administration, or the NCA;

the State Administration for Industry and Commerce, or the SAIC;

the State Council Information Office, or the SCIO;

the Ministry of Commerce, or the MOFCOM;

the Bureau of Protection of State Secrets;

the Ministry of Public Security; and

the State Administration of Foreign Exchange, or the SAFE.

As the online social platform and online game industries are still at an early stage of development in China, new laws and regulations may be adopted from time to time to require new licenses and permits in addition to those we currently have. There are substantial uncertainties on the interpretation and implementation of any current and future Chinese laws and regulations, including those applicable to the online social platform and online game industries. See "D. Risk Factors Risks Related to Doing Business in China Uncertainties in the interpretation and enforcement of Chinese laws and regulations could limit the legal protections available to you and us." This section sets forth the most important laws and regulations that govern our current business activities in China and that affect the dividends payment to our shareholders.

**Regulation on Telecommunications Services and Foreign Ownership Restrictions**

The Telecommunications Regulations, which became effective on September 25, 2000, are the core regulations on telecommunications services in China. The Telecommunications Regulations set out basic guidelines on different types of telecommunications business activities, including the distinction between "basic telecommunications services" and "value-added telecommunications services." According to the Catalog of Telecommunications Business (2003 Amendment), implemented on April 1, 2003 and attached to the Telecommunications Regulations, internet information services are deemed a type of value-added telecommunications services. The Telecommunications Regulations require the operators of value-added telecommunications services to obtain value-added telecommunications business operation licenses from MIIT or its provincial delegates prior to the commencement of such services. Under these regulations, if the value-added telecommunications services offered include mobile network information services, the operation license for value-added telecommunications business must include the provision of such services in its covered scope. We currently, through Guangzhou Huaduo, our PRC consolidated affiliated entity, hold an

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ICP license, a sub-category of the value-added telecommunications business operation license, covering the provision of internet and mobile network information services, issued by the Guangdong branch of the MIIT on February 10, 2012.

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The Regulations for the Administration of Foreign-Invested Telecommunications Enterprises, or the FITE Regulations, which took effect on January 1, 2002 and were amended on September 10, 2008, are the key regulations that regulate foreign direct investment in telecommunications companies in China. The FITE Regulations stipulate that the foreign investor of a telecommunications enterprise is prohibited from holding more than 50% of the equity interest in a foreign-invested enterprise that provides value-added telecommunications services, including online games and the provision of internet content. Moreover, such foreign investor shall demonstrate a good track record and experience in operating value-added telecommunications services when applying for the value-added telecommunications business operation license from the MIIT.

On July 13, 2006, the MIIT issued the Circular on Strengthening the Administration of Foreign Investment in Value-added Telecommunications Services, or the MIIT Circular 2006, which requires that (a) foreign investors can only operate a telecommunications business in China through establishing a telecommunications enterprise with a valid telecommunications business operation license; (b) domestic license holders are prohibited from leasing, transferring or selling telecommunications business operation licenses to foreign investors in any form, or providing any resource, sites or facilities to foreign investors to facilitate the unlicensed operation of telecommunications business in China; (c) value-added telecommunications service providers or their shareholders must directly own the domain names and registered trademarks they use in their daily operations; (d) each value-added telecommunications service provider must have the necessary facilities for its approved business operations and maintain such facilities in the geographic regions covered by its license; and (e) all value-added telecommunications service providers should improve network and information security, enact relevant information safety administration regulations and set up emergency plans to ensure network and information safety. The provincial communications administration bureaus, as local authorities in charge of regulating telecommunications services, (a) are required to ensure that existing qualified value-added telecommunications service providers will conduct a self-assessment of their compliance with the MIIT Circular 2006 and submit status reports to the MIIT before November 1, 2006; and (b) may revoke the value-added telecommunications business operation licenses of those that fail to comply with the above requirements or fail to rectify such non-compliance within specified time limits. Due to the lack of any additional interpretation from the regulatory authorities, it remains unclear what impact MIIT Circular 2006 will have on us or the other PRC internet companies with similar corporate and contractual structures.

To comply with such foreign ownership restrictions, we operate our online social platform and online game businesses in China through Guangzhou Huaduo, which is owned by several PRC citizens and Beijing Tuda. Beijing Tuda is owned by Messrs. David Xueling Li, Tony Bin Zhao and Jin Cao. Guangzhou Huaduo and Beijing Tuda are both controlled by Beijing Huanju Shidai through a series of contractual arrangements. See "Item 7. Major Shareholders and Related Party Transactions B. Related Party Contractual Arrangements with Beijing Tuda." Moreover, Guangzhou Huaduo is the registered holder of a majority of the domain names, trademarks and facilities necessary for daily operations in compliance with the MIIT Circular 2006. Based on our PRC legal counsel Fangda Partners' understanding of the current PRC laws, rules and regulations, our corporate structure complies with all existing PRC laws and regulations. However, we were further advised by our PRC legal counsel that there are substantial uncertainties with respect to the interpretation and application of existing or future PRC laws and regulations and thus there is no assurance that Chinese governmental authorities would take a view consistent with the opinions of our PRC legal counsel.

**Internet Information Services**

The Administrative Measures on Internet Information Services, or the ICP Measures, issued by the State Council on September 25, 2000 and amended on January 8, 2011, regulate the provision of internet information services. According to the ICP Measures, "internet information services" refer to



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services that provide internet information to online users, and are categorized as either commercial services or non-commercial services. Pursuant to the ICP Measures, internet information commercial service providers shall obtain an ICP license, from the relevant local authorities before engaging in the providing of any commercial internet information services in China. In addition, if the internet information services involve provision of news, publication, education, medicine, health, pharmaceuticals, medical equipment and other services that statutorily require approvals from other additional governmental authorities, such approvals must be obtained before applying for the ICP license. Guangzhou Huaduo presently holds the ICP license on internet and mobile network information services issued by the Guangdong branch of the MIIT on February 10, 2012.

Besides, the ICP Measures and other relevant measures also ban the internet activities that constitute publication of any content that propagates obscenity, pornography, gambling and violence, incite the commission of crimes or infringe upon the lawful rights and interests of third parties, among others. If an internet information service provider detects information transmitted on their system that falls within the specifically prohibited scope, such provider must terminate such transmission, delete such information immediately, keep records and report to the governmental authorities in charge. Any provider's violation of these prescriptions will lead to the revocation of its ICP license and, in serious cases, the shutting down of its internet systems.

**Internet Publication and Cultural Products**

The Tentative Measures for Internet Publication Administration, or Internet Publication Measures, were jointly promulgated by the GAPP and the MIIT on June 27, 2002 and became effective on August 1, 2002. The Internet Publication Measures imposed a license requirement for any company that engages in internet publishing, which means any act by an internet information service provider to select, edit and process content or programs and to make such content or programs publicly available on the internet. The provision of online games is deemed an internet publication activity; therefore, an online game operator must (i) obtain an Internet Publishing License so that it can directly offer its online games to the public in the PRC, or (ii) publish its online games through a qualified press entity by entering into an entrustment agreement.

The Rules for the Administration of Electronic Publication, or the Electronic Publication Rules, was issued by the GAPP on February 21, 2008 and became effective on April 15, 2008. Under the Electronic Publication Rules and other regulations issued by the GAPP, online games are classified as a kind of electronic publication, and publishing of online games is required to be conducted by licensed electronic publishing entities that have been issued standard publication codes. Pursuant to the Electronic Publication Rules, if a PRC company is contractually authorized to publish foreign electronic publications, it must obtain the approval of, and register the copyright license contract with, the GAPP.

We, through Guangzhou Huaduo, obtained an Internet Publishing License for the publication of online games and mobile phone games on November 7, 2011. With the issued Internet Publishing License, we are in the process of applying for the GAPP's pre-approval for publishing online games. For more information on the pre-approval by the GAPP, see " Regulation on Online Games and Foreign Ownership Restrictions."

**Regulation on Online Games and Foreign Ownership Restrictions**

On June 3, 2010, the MOC promulgated the Provisional Administration Measures of Online Games, or the Online Game Measures, which came into effect on August 1, 2010. The Online Game Measures governs the research, development and operation of online games and the issuance and trading services of virtual currency. It specifies that the MOC is responsible for the censorship of imported online games and the filing of records of domestic online games. The procedures for the filing of records of domestic online games must be conducted with the MOC within 30 days after the

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commencement date of the online operation of such online games or the occurrence date of any material alteration of such online games.

All operators of online games, issuers of virtual currencies and providers of virtual currency trading services, or Online Game Business Operators, are required to obtain Internet Culture Operation Licenses. An Internet Culture Operation License is valid for three years and in case of renewal, the renewal application should be submitted 30 days prior to the expiry date of such license. An Online Game Business Operator should request the valid identity certificate of game users for registration, and notify the public 60 days ahead of the termination of any online game operations or the transfer of online game operational rights. Online Game Business Operators are also prohibited from (a) setting compulsory matters in the online games without game users' consent; (b) advertising or promoting the online games that contain prohibited content, such as anything that compromise state security or divulges state secrets; and (c) inducing game users to input legal currencies or virtual currencies to gain online game products or services, by way of random draw or other incidental means. It also states that the state cultural administration authorities will formulate the compulsory clauses of a standard online game service agreement, which have been promulgated on July 29, 2010 and are required to be incorporated into the service agreement entered into between the Online Game Business Operators, with no conflicts with the rest of clauses in such service agreements. Guangzhou Huaduo holds a valid Internet Culture Operation License that was last updated in December 2013.

On July 11, 2008, the General Office of the State Council promulgated the Regulation on Main Functions, Internal Organization and Staffing of the GAPP, or the Regulation on Three Provisions. On September 7, 2009, the Central Organization Establishment Commission issued the corresponding interpretations, or the Interpretations on Three Provisions. The Regulation on Three Provisions and the Interpretation on Three Provisions granted the MOC overall jurisdiction to regulate the online gaming industry, and granted the GAPP the authority to issue approvals for the internet publication of online games. Specifically, (a) the MOC is empowered to administrate online games (other than the pre-examination and approval before internet publication of online games); (b) subject to the MOC's overall administration, GAPP is responsible for the pre-examination and approval of the internet publication of online games; and (c) once an online game is launched, the online game will be only administrated and regulated by the MOC. On November 7, 2011, Guangzhou Huaduo obtained an Internet Publishing License for the publication of online games and mobile phone games. The online games we currently offer are domestically produced games, and are published by third parties qualified to publish online games. Approximately 88% of the online games currently available on YY Client have been filed with the GAPP as electronic publications, and the others are still undergoing the filing process.

On September 28, 2009, the GAPP, the NCA and the National Working Group to Eliminate Pornography and Illegal Publications jointly issued the Circular on Consistent Implementation of the Stipulation on the Three Determinations of the State Council and the Relevant Interpretations of the State Commission for Public Sector Reform and the Further Strengthening of the Pre-approval of Online Games and the Approval and Examination of Imported Online Games, or Circular 13. Circular 13 explicitly prohibits foreign investors from directly or indirectly engaging in online gaming business in China, including through variable interest entity structures, or VIE Structures. Foreign investors are not allowed to indirectly control or participate in PRC operating companies' online game operations, whether (a) by establishing other joint ventures, entering into contractual arrangements or providing technical support for such operating companies; or (b) in a disguised form such as by incorporating or directing user registration, user account management or game card consumption into online gaming platforms that are ultimately controlled or owned by foreign companies. Circular 13 reiterates that the GAPP is responsible for the examination and approval of the import and publication of online games and states that downloading from the internet is considered a publication activity, which is subject to approval from the GAPP. Violations of Circular 13 will result in severe penalties.

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For detailed analysis, see "D. Risk Factors Risks Related to Our Corporate Structure and Our Industry We may be adversely affected by the complexity, uncertainties and changes in PRC regulation of internet business and companies."

**Anti-fatigue Compliance System and Real-name Registration System**

On April 15, 2007, in order to curb addictive online game-playing by minors, eight PRC government authorities, including the GAPP, the Ministry of Education, the Ministry of Public Security and the MIIT, jointly issued a circular requiring the implementation of an anti-fatigue compliance system and a real-name registration system by all PRC online game operators. Under the anti-fatigue compliance system, three hours or less of continuous playing by minors, defined as game players under 18 years of age, is considered to be "healthy", three to five hours is deemed "fatiguing", and five hours or more is deemed "unhealthy." Game operators are required to reduce the value of in-game benefits to a game player by half if it discovers that the amount of a time a game player spends online has reached the "fatiguing" level, and to zero in the case of the "unhealthy" level.

To identify whether a game player is a minor and thus subject to the anti-fatigue compliance system, a real-name registration system should be adopted to require online game players to register their real identity information before playing online games. Pursuant to a notice issued by the relevant eight government authorities on August 3, 2011, online game operators must submit the identity information of game players to the National Citizen Identity Information Center, a subordinate public institution of the Ministry of Public Security, for verification as of October 1, 2011.

We have developed and implemented an anti-fatigue and compulsory real-name registration system in all our online games, and will cooperate with the National Citizen Identity Information Center to launch the identity verification system upon the issuance of relevant implementing rules. For game players who do not provide verified identity information, we assume that they are minors under 18 years of age. In order to comply with the anti-fatigue rules, we set up our system so that after three hours of playing our online games, minors only receive half of the virtual items or other in-game benefits they would otherwise earn, and after playing for more than five hours, minors would receive no in-game benefits. These restrictions could limit our ability to increase our online games business among minors. Furthermore, if these restrictions were expanded to apply to adult game players in the future, our online games business could be materially and adversely affected. See "D. Risk Factors Risks Related to Our Corporate Structure and Our Industry Intensified government regulation of the internet industry in China could restrict our ability to maintain or increase our user level or the level of user traffic to our YY platform.

**Virtual Currency**

On January 25, 2007, the Ministry of Public Security, the MOC, the MIIT and the GAPP jointly issued a circular regarding online gambling which has implications for the issuance and use of virtual currency. To curtail online games that involve online gambling while addressing concerns that virtual currency might be used for money laundering or illicit trade, the circular (a) prohibits online game operators from charging commissions in the form of virtual currency in connection with winning or losing of games; (b) requires online game operators to impose limits on use of virtual currency in guessing and betting games; (c) bans the conversion of virtual currency into real currency or property; and (d) prohibits services that enable game players to transfer virtual currency to other players. To comply with the relevant section of the circular that bans the conversion of virtual currency into real currency or property, in relation to online music and entertainment, our virtual currency currently can only be used by users to exchange into virtual items to be used to show support for performers or gain access to privileges and special features in the channels which are services in nature instead of "real currency or property." Once the virtual currency is exchanged by users for virtual items or the relevant privileged services, the conversion transaction is completed and we immediately cancel the virtual item

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in our internal system. In the case of virtual items used as gifts to performers, we cancel the virtual items and record corresponding points for the benefit of the performers and the channel owners, which are then used as basis for the revenue-sharing calculation pursuant to arrangements among us, certain popular performers and channel owners.

In February 2007, 14 PRC regulatory authorities jointly issued a circular to further strengthen the oversight of internet cafes and online games. In accordance with the circular, the People's Bank of China, or PBOC, has the authority to regulate virtual currency, including: (a) setting limits on the aggregate amount of virtual currency that can be issued by online game operators and the amount of virtual currency that can be purchased by an individual; (b) stipulating that virtual currency issued by online game operators can only be used for purchasing virtual products and services within the online games and not for purchasing tangible or physical products; (c) requiring that the price for redemption of virtual currency shall not exceed the respective original purchase price; and (d) banning the trading of virtual currency.

On June 4, 2009, the MOC and the MOFCOM jointly issued a notice to strengthen the administration of online game virtual currency. The Virtual Currency Notice requires businesses that (a) issue online game virtual currency (in the form of prepaid cards and/or pre-payment or prepaid card points), or (b) offer online game virtual currency transaction services to apply for approval from the MOC through its provincial branches within three months after the issuance of the notice. The Virtual Currency Notice prohibits businesses that issue online game virtual currency from providing services that would enable the trading of such virtual currency. Any business that fails to submit the requisite application will be subject to sanctions, including, without limitation, mandatory corrective measures and fines.

Under the Virtual Currency Notice, an online game virtual currency transaction service provider means a business providing platform services relating to trading of online game virtual currency among game users. The Virtual Currency Notice further requires an online game virtual currency transaction service provider to comply with relevant e-commerce regulations issued by the MOFCOM. According to the Guiding Opinions on Online Trading (Interim) issued by the MOFCOM on March 6, 2007, online platform services are trading services provided to online buyers and sellers through a computer information system operated by the service provider.

The Virtual Currency Notice regulates, among others, the amount of virtual currency a business can issue, the retention period of user records, the function of virtual currency and the return of unused virtual currency upon the termination of online services. It prohibits online game operators from distributing virtual items or virtual currency to players based on random selection through lucky draw, wager or lottery which involves cash or virtual currency directly paid by the players. The Virtual Currency Notice bans the issuance of virtual currency by game operators to game players through means other than purchases with legal currency. Any business that does not provide online game virtual currency transaction services is required to adopt technical measures to restrict the transfer of online game virtual currency among accounts of different game players.

In addition, the Online Game Measures promulgated in June 2010 further provide that (i) virtual currency may only be used to purchase services and products provided by the online service provider that issues the currency; (ii) the purpose of issuing virtual currency shall not be malicious appropriation of the user's advance payment; (iii) the storage period of online gamers' purchase record shall not be shorter than 180 days; (iv) the types, price and total amount of virtual currency shall be filed with the cultural administration department at the provincial level. The Online Game Measures stipulate that virtual currency service providers may not provide virtual currency transaction services to minors or for online games that fail to obtain the necessary approval or filings, and that such providers should keep transaction records, accounting records and other relevant information for its users for at least 180 days.

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**Online Music and Entertainment**

On November 20, 2006, the MOC issued Several Suggestions of the MOC on the Development and Administration of Internet Music, or the Suggestions, which became effective on the same date. The Suggestions, among other things, reiterate the requirement for an internet service provider to obtain an Internet Culture Operation License to carry out any business relating to internet music products. In addition, foreign investors are prohibited from operating internet culture businesses. However, the laws and regulations on internet music products are still evolving, and there have not been any provisions clarifying whether music products will be regulated by the Suggestions or how such regulation would be carried out.

On August 18, 2009, the MOC promulgated the Notice on Strengthening and Improving the Content Review of Online Music, or the Online Music Notice. According to the Online Music Notice, only "internet culture operating entities" approved by the MOC may engage in the production, release, dissemination (including providing direct links to music products) and importation of online music products. The content of online music shall be reviewed by or filed with the MOC. Internet culture operating entities should establish a strict self-monitoring system of online music content and set up a special department in charge of such monitoring.

Guangzhou Huaduo holds a valid Internet Culture Operation License covering our provision of online music. More than 99% of the music offered on our websites is sung by grassroots performers along with recorded music. If any music provided through our platform is found to lack necessary filings and/or approvals, we could be requested to cease providing such music or be subject to claims from third parties or penalties from the MOC or its local branches. See "D. Risk Factors Risks Related to Our Corporate Structure and Our Industry If our PRC consolidated affiliated entities fail to obtain and maintain the requisite licenses and approvals required under the complex regulatory environment for internet-based businesses in China, our business, financial condition and results of operations may be materially and adversely affected." Moreover, the unauthorized posting of online music on our platform by third parties may expose us to the risk of administrative penalties and intellectual property infringement lawsuits. See "D. Risk Factors Risks Related to Our Business We may be held liable for information or content displayed on, retrieved from or linked to our platform, or distributed to our users, and PRC authorities may impose legal sanctions on us, including, in serious cases, suspending or revoking the licenses necessary to operate our platform" and "PRC Regulation Intellectual Property Rights Copyright Law."

In 2011, the MOC greatly intensified its regulation of the provision of online music products. According to the series of Notices on Clearing Online Music Products that are in Violation of Relevant Regulations promulgated by the MOC since January 7, 2011, entities that provide any the following will be subject to relevant penalties or sanctions imposed by the MOC: (a) online music products or relevant services without obtaining corresponding qualifications, (b) imported online music products that have not passed the content review of the MOC or (c) domestically developed online music products that have not been filed with the MOC. Thus far, we believe that we have eliminated from our platform any online music products that may fall into the scope of those prohibited online music products thereunder.

**Online Transmission of Audio-Visual Programs**

The Measures for the Administration of Publication of Audio-Visual Programs through Internet or Other Information Network, or the Audio-Visual Measures, promulgated by the SARFT on July 6, 2004 and put into effect on October 11, 2004, apply to the activities relating to the opening, broadcasting, integration, transmission or download of audio-visual programs using internet or other information network. Under the Audio-Visual Measures, to engage in the business of transmitting audio-visual programs, a license issued by SARFT is required. Foreign invested enterprises are not allowed to carry out such business.

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On April 13, 2005, the State Council promulgated the Certain Decisions on the Entry of the Non-state-owned Capital into the Cultural Industry. On July 6, 2005, five PRC governmental authorities, including the MOC, the SARFT, the GAPP, the CSRC and the MOFCOM, jointly adopted the Several Opinions on Canvassing Foreign Investment into the Cultural Sector. According to these regulations, non-state-owned capital and foreign investors are not allowed to engage in the business of transmitting audio-visual programs through information networks.

To further regulate the provision of audio-visual program services to the public via the internet, including through mobile networks, within the territory of the PRC, the SARFT and the MIIT jointly promulgated the Administrative Provisions on Internet Audio-Visual Program Service, or the Audio-Visual Program Provisions, on December 20, 2007, which came into effect on January 31, 2008. Providers of internet audio-visual program services are required to obtain a License for Online Transmission of Audio-Visual Programs issued by SARFT, or complete certain registration procedures with SARFT. In general, providers of internet audio-visual program services must be either state-owned or state-controlled entities, and the business to be carried out by such providers must satisfy the overall planning and guidance catalog for internet audio-visual program service determined by SARFT. In a press conference jointly held by SARFT and MIIT to answer questions relating to the Audio-Visual Program Provisions in February 2008, SARFT and MIIT clarified that providers of internet audio-visual program services who engaged in such services prior to the promulgation of the Audio-Visual Program Provisions are eligible to register their business and continue their operation of internet audio-visual program services so long as those providers did not violate the relevant laws and regulations in the past. On May 21, 2008, SARFT issued a Notice on Relevant Issues Concerning Application and Approval of License for the Online Transmission of Audio-Visual Programs, which further sets out detailed provisions concerning the application and approval process regarding the License for Online Transmission of Audio-Visual Programs. The notice also states that providers of internet audio-visual program services that engaged in such services prior to the promulgation of the Audio-Visual Program Provisions are eligible to apply for the license so long as their violation of the laws and regulations is minor in scope and can be rectified in a timely manner and they have no records of violation during the last three months prior to the promulgation of the Audio-Visual Program Provisions. Further, on March 31, 2009, SARFT promulgated the Notice on Strengthening the Administration of the Content of Internet Audio-Visual Programs, which reiterates the pre-approval requirements for the audio-visual programs transmitted via the internet, including through mobile networks, where applicable, and prohibits certain types of internet audio-visual programs containing violence, pornography, gambling, terrorism, superstition or other similarly prohibited elements.

On April 1, 2010, the SARFT issued the Internet Audio-visual Program Services Categories (Provisional), or the Provisional Categories, which classified internet audio-visual program services into four categories.

Guangzhou Huaduo holds a valid License for Online Transmission of Audio-Visual Programs with the business classification of converging and play-on-demand service for certain kinds of audio-visual programs literary, artistic and entertaining as prescribed in the Provisional Categories and is in the process of reviewing this license.

**Production of Radio and Television Programs**

On July 19, 2004, the SARFT issued the Regulations on the Administration of Production of Radio and Television Programs, or the Radio and TV Programs Regulations, which become effective on August 20, 2004. The Radio and TV Programs Regulations require any entities engaging in the production of radio and television programs to obtain a license for such businesses from the SARFT or its provincial branches. Entities with the License for Production and Operation of Radio and TV Programs must conduct their business operations strictly in compliance with the approved scope of

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production and operations and these entities (except radio and TV stations) must not produce radio and TV programs regarding current political news or similar subjects.

Guangzhou Huaduo holds an effective License for Production and Operation of Radio and TV Programs, issued on October 8, 2011, covering the production, reproduction and publication of broadcasting plays, TV dramas, cartoons (excluding production), special subjects, special columns (excluding current political news category) and entertainment programs.

**Regulation on Internet Bulletin Board Services**

On November 6, 2000, the MIIT promulgated the Administrative Measures on Internet Bulletin Board Services, or BBS Measures, which required commercial internet information service providers which provide bulletin boards, discussion forums, chat rooms or similar services, or BBS services, to obtain specific approval from the competent telecommunications authorities. Commercial internet information service providers are also required to conspicuously display their ICP license numbers and the rules of the BBS and inform users of the possible legal liabilities and consequences for posting improper comments. Another notice issued by the MIIT in March 2001 further specified the qualifications and requirements for approval of BBS services and emphasized the principles of daily supervision on BBS services.

The above-stated administrative approval or filing requirement for BBS was cancelled on July 4, 2010.

**Online Education Services**

On July 5, 2000, the Ministry of Education promulgated the Measures for the Administration of Educational Websites and Online Schools. Accordingly, an entity that operates educational websites and online schools is required to obtain prior approval from the competent administrative educational authorities. Educational websites are defined as institutions which establish online information databases by collecting, editing and storing educational information or establish online platform and search tools for educational purposes, and which provide public educational information to website visitors or users through the internet or educational TV stations. These measures also include specific provisions regarding the qualifications and procedures for obtaining the approval for operating educational websites. We currently offer some education-related services on our platform and have obtained approval from relevant authorities to provide online education content on edu.YY.com and 100.com, on January 17, 2013 and January 16, 2014, respectively.

**Regulation on Advertising Business and Conditions on Foreign Investment**

The SAIC is the primary governmental authority regulating advertising activities in China. Regulations that apply to advertising business primarily include:

Advertisement Law of the People's Republic of China, promulgated by the Standing Committee of the National People's Congress on October 27, 1994 and effective since February 1, 1995;

Administrative Regulations for Advertising, promulgated by the State Council on October 26, 1987 and effective since December 1, 1987; and

Implementation Rules for the Administrative Regulations for Advertising, promulgated by the State Council on January 9, 1988 and amended on December 3, 1998, December 1, 2000 and November 30, 2004, respectively.

According to the above regulations, companies that engage in advertising activities must each obtain, from the SAIC or its local branches, a business license which specifically includes operating an advertising business in its business scope. An enterprise engaging in advertising business within the

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specifications in its business scope does not need to apply for an advertising operation license, provided that such enterprise is not a radio station, television station, newspaper or magazine publisher or any other entity otherwise specified in the relevant laws or administrative regulations. Enterprises conducting advertising activities without such a license may be subject to penalties, including fines, confiscation of advertising income and orders to cease advertising operations. The business license of an advertising company is valid for the duration of its existence, unless the license is suspended or revoked due to a violation of any relevant laws or regulations.

PRC advertising laws and regulations set certain content requirements for advertisements in China, including, among other things, prohibitions on false or misleading content, superlative wording, socially destabilizing content or content involving obscenities, superstition, violence, discrimination or infringement of the public interest. Advertisers, advertising agencies, and advertising distributors are required to ensure that the content of the advertisements they prepare or distribute is true and in complete compliance with applicable laws. In providing advertising services, advertising operators and advertising distributors must review the supporting documents provided by advertisers for advertisements and verify that the content of the advertisements complies with applicable PRC laws and regulations. Prior to distributing advertisements that are subject to government censorship and approval, advertising distributors are obligated to verify that such censorship has been performed and approval has been obtained. Violation of these regulations may result in penalties, including fines, confiscation of advertising income, orders to cease dissemination of the advertisements and orders to publish an advertisement correcting the misleading information. Where serious violations occur, the SAIC or its local branches may revoke such offenders' licenses or permits for their advertising business operations.

Under the Administrative Regulations on Foreign-Invested Advertising Enterprises, promulgated in 2008, there is no longer any maximum foreign shareholding percentage restriction applicable to foreign-invested advertising enterprises. However, foreign investors are required to have at least three years prior experience of operating an advertising business outside of China as their main business before receiving approval to directly own a 100% interest in an advertising company in China. Foreign investors with at least two years prior experience of operating an advertising business outside China as their main business are allowed to establish a joint venture with domestic advertising enterprises to operate an advertising business in China.

**Intellectual Property Rights**

*Software Registration*

The State Council and the NCA have promulgated various rules and regulations and rules relating to protection of software in China. According to these rules and regulations, software owners, licensees and transferees may register their rights in software with the SCB or its local branches and obtain software copyright registration certificates. Although such registration is not mandatory under PRC law, software owners, licensees and transferees are encouraged to go through the registration process and registered software rights may be entitled to better protections. For the number of software programs for which we had registered rights as of December 31, 2012, see "Item 4. Information on the Company B. Business Overview Intellectual Property."

*Patents*

The National People's Congress adopted the Patent Law of the People's Republic of China in 1984 and amended it in 1992, 2000 and 2008, respectively. A patentable invention, utility model or design must meet three conditions: novelty, inventiveness and practical applicability. Patents cannot be granted for scientific discoveries, rules and methods for intellectual activities, methods used to diagnose or treat diseases, animal and plant breeds or substances obtained by means of nuclear transformation. The



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Patent Office under the State Intellectual Property Office is responsible for receiving, examining and approving patent applications. A patent is valid for a twenty-year term for an invention and a ten-year term for a utility model or design, starting from the application date. Except under certain specific circumstances provided by law, any third party user must obtain consent or a proper license from the patent owner to use the patent, or else the use will constitute an infringement of the rights of the patent holder. For the number of patents we had and the number of patent applications we made as of December 31, 2012, see "Item 4. Information on the Company B. Business Overview Intellectual Property."

***Copyright Law***

The Copyright Law of the People's Republic of China, promulgated in 1990 and amended in 2001 and 2010, or the Copyright Law, and its related implementing regulations, promulgated in 2002 and amended in 2013, are the principal laws and regulations governing the copyright related matters. The amended Copyright law covers internet activities, products disseminated over the internet and software products, among the subjects entitled to copyright protections. Registration of copyright is voluntary, and is administrated by the China Copyright Protection Center.

To further clarify some key internet copyright issues, on November 26, 2012, the PRC Supreme People's Court promulgated the Regulation on Several Issues Concerning Applicable Laws on Trial of Civil Disputes over the Infringement of Information Network Transmission Right, or the 2013 Regulation. The 2013 Regulation took effect on January 1, 2013, and replaced the Interpretations on Some Issues Concerning Applicable Laws for Trial of Disputes over Internet Copyright that was initially adopted in 2000 and subsequently amended in 2004 and 2006. Under the 2013 Regulation, where an internet information service provider work in cooperation with others to jointly provide works, performances, audio and video products of which the right holders have information network transmission right, such behavior will constitute joint infringement of third parties' information network transmission right, and the PRC court shall order such internet information service provider to assume joint liability for such infringement. If an internet information service provider can prove that it has only provided network services through automatic access, automatic transmission, data storage space, search functions, links, document sharing technology, etc., and thereby argues that it has not been involved in any alleged joint infringement, the PRC court shall find in favor of such internet information service provider. If an internet information service provider fails to delete, block, disconnect or take other necessary measures, or if it provides technological support or other aid when it knows or should have known of the network user's infringement on the information network transmission right, the PRC court shall find that such aid constitutes contributory infringement. The PRC court shall determine whether an internet information service provider is liable for abetting or contributory infringement according to its findings on the degree of fault of the internet information service provider. The fault of the internet information service provider is determined according to various criteria, including situations where such provider knew or should have known of the network user's infringement against third party's information network transmission right. If an internet information service provider can prove it has adopted fairly reasonable and effective technological measures, and yet still finds it difficult to discover infringement against information network transmission conducted by the network user, the PRC court shall find such provider to be not at fault. Where an internet information service provider promotes popular video and films through setting up a list, directory, index, descriptive paragraph, briefing or other means of recommendation, and the public can download, browse or acquire them through other methods directly from the internet information service provider's webpage, the PRC court may find that such provider knew of the network user's infringement on the information network transmission right of others.

Under the Copyright Law and its implementation rules, anyone infringing upon the copyrights of others is subject to various civil liabilities, which include stopping the infringement, eliminating the

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damages, apologizing to the copyright owners and compensating the copyright owners for such owners' actual and other losses resulting from such infringement. If the actual loss of the copyright owner is difficult to calculate, the income received by the offender as a result of the copyright infringement shall be deemed to be the actual loss; or if such income is in itself difficult to calculate, the relevant PRC court may decide the amount of the actual loss up to RMB500,000 for each infringement.

To address the problem of copyright infringement related to content posted or transmitted on the internet, the PRC National Copyright Administration and MIIT jointly promulgated the Measures for Administrative Protection of Copyright Related to Internet on April 29, 2005. These measures, which became effective on May 30, 2005, apply to acts of automatically providing services such as uploading, storing, linking or searching works, audio or video products, or other contents through the internet based on the instructions of internet users who publish contents on the internet, or the Internet Content Providers, without editing, amending or selecting any stored or transmitted content. When imposing administrative penalties upon the act which infringes upon any users' right of communication through information networks, the Measures for Imposing Copyright Administrative Penalties, promulgated in 2009, shall be applied.

Where a copyright holder finds that certain internet content infringes upon its copyright and sends a notice to the relevant internet information service operator, the relevant internet information service operator is required to (i) immediately take measures to remove the relevant contents, and (ii) retain all infringement notices for six months and to record the content, display time and IP addresses or the domain names related to the infringement for 60 days. After any content is removed by an internet information service operator according to the notice of a copyright holder, the content provider may deliver a counter-notice to both the internet information service operator and the copyright holder, stating that the removed content does not infringe upon the copyright of other parties. After the delivery of such counter-notice, the internet information service operator may immediately reinstate the removed contents and shall not bear administrative legal liability for such reinstatement.

An internet information service operator may be subject to cease-and-desist orders and other administrative penalties such as confiscation of illegal income and fines, if it is clearly aware of a copyright infringement through the internet or, although not aware of such infringement, it fails to take measures to remove relevant content upon receipt of the copyright owner's notice of infringement and, as a result, damages public interests. Where there is no evidence to indicate that an internet information service operator is clearly aware of the existence of copyright infringement, or the internet information service operator has taken measures to remove relevant contents upon receipt of the copyright owner's notice, the internet information service provider shall not bear the relevant administrative legal liabilities.

On May 18, 2006, the State Council issued the Protection of the Right of Communication through Information Network, which took effect on July 1, 2006 and amended on January 30, 2013. Under this regulation, an internet information service provider may be exempt from indemnification liabilities under the following circumstances:

any internet information service provider that provides automatic internet access service upon instructions from its users or provides automatic transmission service for works, performances and audio-visual products provided by its users are not required to assume indemnification liabilities if (a) it has not chosen or altered the transmitted works, performance and audio-visual products and (b) it provides such works, performances and audio-visual products to the designated users and prevents any person other than such designated users from obtaining access.

any internet information service provider that, for the sake of improving network transmission efficiency, automatically stores and provides to its own users the relevant works, performances and audio-visual products obtained from any other internet information service providers, are

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not required to assume the indemnification liabilities if (a) it has not altered any of the works, performance or audio-visual products that are automatically stored; (b) it has not affected such original internet information service provider in holding the information about where the users obtain the relevant works, performance and audio-visual products; and (c) when the original internet information service provider revises, deletes or shields the works, performances and audio-visual products, it will automatically revise, delete or shield the same.

any internet information service provider that provides its users with information memory space for such users to provide the works, performances and audio-visual products to the general public via an informational network are not required to assume the indemnification liabilities if (a) it clearly indicates that the information memory space is provided to the users and publicizes its own name, contact person and web address; (b) it has not altered the works, performance and audio-visual products that are provided by the users; (c) it is not aware of or has no reason to know that the works, performances and audio-visual products provided by the users infringe upon the copyrights of others; (d) it has not directly derived any economic benefit from the providing of the works, performances and audio-visual products by its users; and (e) after receiving a notice from the copyright holder, it promptly deletes the allegedly infringing works, performances and audio-visual products pursuant to the relevant regulation.

Since 2005, the NCA, together with certain other PRC governmental authorities, have jointly launched annual campaigns specifically aimed to crack down on internet copyright infringement and piracy in China; these campaigns normally last for three to four months every year. According to the Notice of 2010 Campaign to Crack Down on Internet Infringement and Piracy promulgated by the NCA, the Ministry of Public Security and the MIIT on July 19, 2010, the 2010 campaign mainly targeted internet audio and video programs, literature websites, online games, animation, software and art works related to Shanghai World Expo and Guangzhou Asian Games. During the 2010 campaign, starting from late July to the end of October 2010, the local branches of NCA focused on popular movies and TV series, newly published books, online games and animation, music and software and various illegal activities, including, for example, illegal uploading or transmission of a third party's works without proper license or permission, sales of pirated audio-video and software through e-commerce platforms, providing search links, information storage, web hosting or internet access services for third parties engaging in copyright infringement or piracy of copyrighted works and the infringement by use of mobile media. In serious cases, the operating permits of the websites engaging illegal activities were revoked, and such websites were ordered to shut down.

We have adopted measures to mitigate copyright infringement risks. For instance, we have established a routine reporting and registration system that is updated on a monthly basis, and we require performers, channel owners and users to acknowledge and agree that (a) they would not perform or upload copyrighted content without proper authorization and (b) that they will indemnify us for any relevant copyright infringement claims in relation to their activities on our platform.

If, despite these precautions, such procedures fail to effectively prevent unauthorized posting or use of copyrighted content or the infringement of other third party rights on YY platform, and the PRC courts find that certain safe harbor exemptions under PRC laws are not applicable to us because, for instance, a court finds that we knew or should have known about such infringement or that we have directly derived economic benefits from allowing such infringement activities on our platform, we may be held jointly and severally liable with the performers, channel owners or other infringement parties in lawsuits initiated by the relevant third party copyright holders or authorized users. Moreover, we may be held directly liable for the infringement activities of such performers or channel owners on YY platform, if the PRC courts view them as our employees or agents, deem us to have control over their activities on our platform and the content they upload or otherwise make available on our platform, and determine that we have knowingly uploaded such infringing contents on our platform. See "D. Risk Factors Risks Related to Our Business We may be subject to intellectual property

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infringement claims or other allegations, which could result in our payment of substantial damages, penalties and fines, removal of relevant content from our website or seeking license arrangements which may not be available on commercially reasonable terms."

***Domain Name***

In September 2002, the CNNIC issued the Implementing Rules for Domain Name Registration setting forth detailed rules for registration of domain names. On November 5, 2004, the MIIT promulgated the Measures for Administration of Domain Names for the Chinese Internet, or the Domain Name Measures. The Domain Name Measures regulate the registration of domain names, such as the first tier domain name ".cn." In February 2006, the CNNIC issued the Measures on Domain Name Dispute Resolution and relevant implementing rules, pursuant to which the CNNIC can authorize a domain name dispute resolution institution to decide disputes. For the number of domain names we registered as of December 31, 2012, see "Item 4. Information on the Company B. Business Overview Intellectual Property."

***Trademark***

The PRC Trademark Law, adopted in 1982 and amended in 1993 and 2001, with its implementation rules adopted in 2002, protects registered trademarks. The Trademark Office of the SAIC handles trademark registrations and grants a protection term of ten years to registered trademarks. Trademark license agreements must be filed with the Trademark Office for record. For the number of trademarks we had and trademark applications we had made as of December 31, 2013, see "Item 4. Information on the Company B. Business Overview Intellectual Property."

**Internet Infringement**

On December 26, 2009, the Standing Committee of National People's Congress promulgated the Tort Law of the People's Republic of China, or the Tort Law, which became effective on July 1, 2010. Under the Tort Law, an internet user or an internet service provider that infringes upon the civil rights or interests of others through using the internet assumes tort liability. If an internet user infringes upon the civil rights or interests of another through using the internet, the person being infringed upon has the right to notify and request the internet service provider whose internet services are facilitating the infringement to take necessary measures including the deletion, blocking or disconnection of an internet link. If, after being notified, the internet service provider fails to take necessary measures in a timely manner to end the infringement, it will be jointly and severally liable for any additional harm caused by its failure to act. According to the Tort Law, civil rights and interests include the personal rights and rights of property, such as the right to life, right to health, right to name, right to reputation, right to honor, right of portraiture, right of privacy, right of marital autonomy, right of guardianship, right to ownership, right to usufruct, right to security interests, copyright, patent right, exclusive right to use trademarks, right to discovery, right to equity interests and right of heritage, among others.

**Regulation of Internet Content**

The PRC government has promulgated measures relating to internet content through a number of governmental agencies, including the MIIT, the MOC and the GAPP. These measures specifically prohibit internet activities, such as the operation of online games, that result in the publication of any content which is found to contain, among others, propagate obscenity, gambling or violence, instigate crimes, undermine public morality or the cultural traditions of the PRC, or compromise state security or secrets. If an ICP license holder violates these measures, its ICP license may be revoked and its websites may be shut down by the relevant government agencies.

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Moreover, according to the Notice on the Work of Purification of Online Games jointly issued by the MOC, the MIIT and other governmental authorities in June 2005, online games in China are required to be registered and filed as software products in accordance with the Administrative Measures on Software Products, promulgated in 2000. In addition, pursuant to the Notice on Enhancing the Content Review Work of Online Game Products promulgated by the MOC in 2004, imported online games are subject to content review by the MOC prior to being offered to Chinese internet users.

**Information Security and Censorship**

Internet content in China is regulated and restricted from a state security standpoint. The National People's Congress, China's national legislative body, enacted the Decisions on the Maintenance of Internet Security on December 28, 2000, that may subject persons to criminal liabilities in China for any attempt to: (i) gain improper entry to a computer or system of strategic importance; (ii) disseminate politically disruptive information; (iii) leak state secrets; (iv) spread false commercial information or (v) infringe upon intellectual property rights.

In 1997, the Ministry of Public Security issued the Administration Measures on the Security Protection of Computer Information Network with Internationally Connections, which prohibit using the internet in ways which, among others, result in a leakage of state secrets or a spread of socially destabilizing content. The Ministry of Public Security has supervision and inspection powers in this regard, and relevant local security bureaus may also have jurisdiction. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its websites.

On December 28, 2012, the Standing Committee of the National People's Congress reiterated relevant rules on the protection of internet information by issuing the Decision on Strengthening the Protection of Network Information, or the 2012 Decision. The 2012 Decision distinctly clarified certain relevant obligations of the internet information service provider. For example, the 2012 Decision specifies that the internet information service provider should take relevant technical measures and other necessary actions to prevent the leakage, damage or loss of each user's personal information collected in the internet information service provider's operation activities, and shall take remedial measures when the leakage, damage or loss of the citizen's personal information occurs or may possibly occur. Once it discovers any transmission or disclosure of information prohibited by the relevant laws and regulations, the internet information service provider shall stop transmission of such information, take measures such as elimination, keeping relevant record, and reporting to relevant authorities.

To comply with the above laws and regulations, we have established an internet information security department to implement measures on information filtering. For example, we have adopted a voice monitor system, and installed on our platform various alerts on sensitive words or abnormal activities of users, channels or groups. We also have a dedicated team that maintains 24-hour surveillance on the information posted on our platform, with different categories for monitoring purposes, according to subject and content. We have also established and follow a strict review process and storage system of relevant records which, in combination with various information security measures, have effectively prevented the public dissemination of statutory prohibited information through our websites in the past. We intend to continue to further update our measurements and system and work closely with relevant authorities to avoid any violation of relevant laws and regulations in the future.

**Privacy Protection**

PRC laws and regulations do not prohibit internet content providers from collecting and analyzing their users' personal information if appropriate authorizations are obtained. We require our users to accept a user agreement whereby they agree to provide certain personal information to us. PRC laws

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and regulations prohibit internet content providers from disclosing any information transmitted by users through their networks to any third parties without their authorization unless otherwise permitted by law. If an internet content provider violates these regulations, the MIIT or its local bureaus may impose penalties and the internet content provider may be liable for damages caused to its users.

**Regulation of Foreign Currency Exchange and Dividend Distribution**

**Foreign Currency Exchange.** The core regulations governing foreign currency exchange in China are the Foreign Exchange Administration Regulations, as amended in August 2008, or the FEA Regulations. Under the FEA Regulations, the Renminbi is freely convertible for current account items, including the distribution of dividends, interest payments, trade- and service-related foreign exchange transactions, but not for capital account items, such as direct investments, loans, repatriation of investments and investments in securities outside of China, unless the prior approval of the SAFE is obtained and prior registration with the SAFE is made. On August 29, 2008, SAFE promulgated Circular 142 to regulate the conversion of foreign currency into Renminbi by a foreign-invested enterprise by restricting the ways in which the converted Renminbi may be used. Circular 142 stipulates that the registered capital of a foreign-invested enterprise that has been settled in Renminbi converted from foreign currencies may only be used for purposes within the business scope approved by the applicable governmental authority and cannot be used for equity investments within the PRC. Meanwhile, the SAFE strengthened its oversight of the flow and use of the registered capital of a foreign-invested enterprise settled in Renminbi converted from foreign currencies. The use of such Renminbi capital may not be changed without the SAFE's approval, and may not in any case be repayment of Renminbi loans if the proceeds of such loans have not been used. Violations of Circular 142 may lead to severe penalties including heavy fines. As a result, Circular 142 may significantly limit our ability to transfer the net proceeds from our initial public offering to our other PRC subsidiaries through Beijing Huanju Shidai, our wholly owned subsidiary in China, and thus may adversely affect our business expansion in China. We may not be able to convert the net proceeds into Renminbi to invest in or acquire any other PRC companies, or establish other VIEs in the PRC.

**Dividend Distribution.** The Foreign Investment Enterprise Law, promulgated in 1986 and amended in 2000, and the Administrative Rules under the Foreign Investment Enterprise Law, promulgated in 2001, are the key regulations governing distribution of dividends of foreign-invested enterprises.

Under these regulations, a wholly foreign-invested enterprise in China, or a WFOE, may pay dividends only out of its accumulated profits, if any, determined in accordance with PRC accounting standards and regulations. In addition, a WFOE is required to allocate at least 10% of its accumulated profits each year, if any, to statutory reserve funds unless its reserves have reached 50% of the registered capital of the enterprises. These reserves are not distributable as cash dividends. The proportional ratio for withdrawal of rewards and welfare funds for employees shall be determined at the discretion of the WFOE. Profits of a WFOE shall not be distributed before the losses thereof before the previous accounting years have been made up. Any undistributed profit for the previous accounting years may be distributed together with the distributable profit for the current accounting year.

**Circular 75.** The SAFE issued Circular on Several Issues concerning Foreign Exchange Administration for Domestic Residents to Engage in Financing and in Return Investments via Overseas Special Purpose Companies, or Circular No. 75, on October 21, 2005, which became effective on November 1, 2005. Under Circular 75, prior registration with the local SAFE branch is required for PRC residents to establish or to control an offshore company for the purposes of financing that offshore company with assets or equity interests in an onshore enterprise located in the PRC. An amendment to registration or filing with the local SAFE branch by such PRC resident is also required for the injection of equity interests or assets of an onshore enterprise in the offshore company or

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overseas funds raised by such offshore company, or any other material change involving a change in the capital of the offshore company.

Circular 75 applies retroactively. PRC residents who have established or acquired control of offshore companies that have made onshore investments in the PRC in the past were required to complete the relevant registration procedures with the local SAFE branch by March 31, 2006. Under the relevant rules, failure to comply with the registration procedures set forth in Circular 75 may lead to restrictions being imposed on the foreign exchange activities of the relevant onshore company, including the increase of its registered capital, the payment of dividends and other distributions to its offshore parent or affiliate and the capital inflow from the offshore entity, and may also subject relevant PRC residents to penalties under PRC foreign exchange administration regulations. PRC residents who control our company from time to time are required to register with the SAFE in relation to their investments in us.

We have completed the foreign exchange registration of PRC resident shareholders of Guangzhou Huaduo, as required by Circular 75, for our financings that were completed before the end of 2010. The Circular 75 registration in relation to the issuance of common shares to Tiger Global Six YY Holdings was completed on February 6, 2012.

**Stock Option Rules.** The Administration Measures on Individual Foreign Exchange Control were promulgated by the PBOC on December 25, 2006, and their Implementation Rules, issued by the SAFE on January 5, 2007, became effective on February 1, 2007. Under these regulations, all foreign exchange matters involved in employee stock ownership plans and stock option plans participated in by onshore individuals, among others, require approval from the SAFE or its authorized branch. Furthermore, the Notices on Issues concerning the Foreign Exchange Administration for Domestic Individuals Participating in Stock Incentive Plans of Overseas Publicly-Listed Companies, or the Stock Option Rules, were promulgated by SAFE on February 15, 2012, that replaced the Application Procedures of Foreign Exchange Administration for Domestic Individuals Participating in Employee Stock Ownership Plans or Stock Option Plans of Overseas Publicly-Listed Companies issued by SAFE on March 28, 2007. Pursuant to the Stock Option Rules, PRC residents who are granted shares or stock options by companies listed on overseas stock exchanges based on the stock incentive plans are required to register with SAFE or its local branches, and PRC residents participating in the stock incentive plans of overseas listed companies shall retain a qualified PRC agent, which could be a PRC subsidiary of such overseas publicly-listed company or another qualified institution selected by such PRC subsidiary, to conduct the SAFE registration and other procedures with respect to the stock incentive plans on behalf of these participants. Such participants must also retain an overseas entrusted institution to handle matters in connection with their exercise of stock options, purchase and sale of corresponding stocks or interests, and fund transfer. In addition, the PRC agents are required to amend the SAFE registration with respect to the stock incentive plan if there is any material change to the stock incentive plan, the PRC agents or the overseas entrusted institution or other material changes. The PRC agents shall, on behalf of the PRC residents who have the right to exercise the employee share options, apply to SAFE or its local branches for an annual quota for the payment of foreign currencies in connection with the PRC residents' exercise of the employee share options. The foreign exchange proceeds received by the PRC residents from the sale of shares under the stock incentive plans granted and dividends distributed by the overseas listed companies must be remitted into the bank accounts in the PRC opened by the PRC agents before distribution to such PRC residents. In addition, the PRC agents shall file each quarter the form for record-filing of information of the Domestic Individuals Participating in the Stock Incentive Plans of Overseas Listed Companies with SAFE or its local branches.

We and our PRC citizen employees who have been granted share options, restricted shares or restricted share units, or PRC optionees, are subject to the Stock Option Rules. If we or our PRC optionees fail to comply with the Individual Foreign Exchange Rule and the Stock Option Rules, we

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and/or our PRC optionees may be subject to fines and other legal sanctions. See "D. Risk Factors Risks Related to Doing Business in China PRC regulations relating to offshore investment activities by PRC residents may limit our PRC subsidiaries' ability to increase their registered capital or distribute profits to us or otherwise expose us to liability and penalties under PRC law."

In addition, the State Administration for Taxation has issued circulars concerning employee share options, under which our employees working in the PRC who exercise share options will be subject to PRC individual income tax. Our PRC subsidiaries have obligations to file documents related to employee share options with relevant tax authorities and to withhold individual income taxes of those employees who exercise their share options. If our employees fail to pay or if we fail to withhold their income taxes as required by relevant laws and regulations, we may face sanctions imposed by the PRC tax authorities or other PRC government authorities.

**Regulation on Tax**

***PRC Enterprise Income Tax***

The PRC enterprise income tax is calculated based on the taxable income determined under the applicable EIT Law and its implementation rules. On March 16, 2007, the National People's Congress of China enacted the New EIT Law, which became effective on January 1, 2008. On December 6, 2007, the State Council promulgated the implementation rules to the New EIT Law, which also became effective on January 1, 2008. The New EIT Law imposes a uniform enterprise income tax rate of 25% on all resident enterprises in China, including foreign-invested enterprises and domestic enterprises, unless they qualify for certain exceptions, and terminates most of the tax exemptions, reductions and preferential treatment available under the previous tax laws and regulations. According to the New EIT Law and relevant regulations, subject to the approval of competent tax authorities, the income tax of an enterprise that has been determined to be a high and new technology enterprise shall be reduced to a preferential rate of 15%.

Moreover, under the New EIT Law, enterprises organized under the laws of jurisdictions outside China with their "de facto management bodies" located within China may be considered PRC resident enterprises and are therefore subject to PRC enterprise income tax at the rate of 25% on their worldwide income.

Although we do not believe that our company should be treated as a PRC resident enterprise for PRC tax purposes, substantial uncertainty exists as to whether we will be deemed to be such by the relevant authorities. In the event that we are considered a PRC resident enterprise, we would be subject to the PRC enterprise income tax at the rate of 25% on our worldwide income. See "D. Risk Factors Risks Related to Doing Business in China Under the PRC enterprise income tax law, we may be classified as a PRC "resident enterprise," which could result in unfavorable tax consequences to us and our shareholders and have a material adverse effect on our results of operations and the value of your investment."

In addition, although the New EIT Law provides that dividend income between "qualified resident enterprises" is exempted income, and the Implementation Rules refer to "qualified resident enterprises" as enterprises with "direct equity interest", it is unclear whether dividends we receive from our PRC subsidiaries are eligible for exemption.



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***PRC Business Tax***

Pursuant to applicable PRC tax regulations, any entity or individual conducting business in the service industry is generally required to pay a business tax at the rate of 5% on the revenues generated from providing services prescribed in the aforesaid regulations, transferring intangible assets or selling immovable properties. However, if the services provided are related to technology development and transfer, such business tax may be exempted with approvals from the competent tax authorities. Before the VAT Pilot Program, revenues from online game operating business is subject to business tax at a rate of 3% and relevant surcharges based on 12% of the business tax paid.

***Value Added Tax***

On January 1, 2012, the State Administration of Taxation officially launched a pilot value added tax ("VAT") reform program ("Pilot Program"), applicable to businesses in selected industries. Taxable income derived from the businesses in the Pilot Program is subject to VAT in lieu of business tax. The Pilot Program initially applied only to transportation industry and "modern service industries" ("Pilot Industries") in Shanghai in 2011 and expanded to eight trial regions (including Beijing and Guangdong province) and nationwide progressively from August to December 2012. The Pilot Industries in Shanghai included industries involving the leasing of tangible movable property, transportation services, research and development and technical services, information technology services, cultural and creative services, logistics and ancillary services, certification and consulting services. Revenues generated by advertising services, a type of "cultural and creative services", are subject to the VAT tax rate of 6%. According to official announcements made by competent authorities in Beijing and Guangdong province, Beijing launched the same Pilot Program on September 1, 2012, and Guangdong province launched it on November 1, 2012. In addition, the Supplementary Notice on Several Tax Policies in Relation to the Scope of VAT-able and Other Matters in the Transportation and Selected Modern Service Sectors under the VAT Reform Pilot Program, Caishui [2012] No. 86, or Circular 86, which was issued in December 2012, further defines the application scope of relevant industries and specifies that, starting from December 1, 2012, website operation services provided by website owners for non-self-owned online games are taxed as "Information System Services," and therefore would also be subject to the VAT tax rate as 6%. Going forward, in Guangdong province, we will pay the pilot VAT instead of business taxes for our advertising activities, operating services for online games not owned by us and for any other parts of our business that are deemed by the competent state tax authorities to be in the scope of the Pilot Industries.

***Cultural Development Fee***

According to applicable PRC tax regulations or rules, advertising service providers are generally required to pay a cultural development fee at the rate of 3% on the revenues (a) which are generated from providing advertising services and (b) which are also subject to VAT after the VAT reform program.

***Dividends Withholding Tax***

Under the Old EIT Law that was effective prior to January 1, 2008, dividends paid to foreign investors by foreign-invested enterprises, such as dividends paid to us by Beijing Huanju Shidai or Guangzhou Huanju Shidai, our PRC subsidiaries, were exempt from PRC withholding tax. We are a Cayman Islands holding company and substantially all of our income may come from dividends we receive from our subsidiaries located in the PRC. Pursuant to the New EIT Law and its implementation rules, dividends generated after January 1, 2008 and distributed to us by our PRC subsidiaries are subject to withholding tax at a rate of 10%.

As uncertainties remain regarding the interpretation and implementation of the New EIT Law and its implementation rules, we cannot assure you that, if we are deemed a PRC resident enterprise, any dividends to be distributed by us to our non-PRC shareholders and ADS holders would not be subject

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to any PRC withholding tax. See "D. Risk Factors Risks Related to Doing Business in China Under the PRC enterprise income tax law, we may be classified as a PRC "resident enterprise," which could result in unfavorable tax consequences to us and our shareholders and have a material adverse effect on our results of operations and the value of your investment."

**Labor Laws and Social Insurance**

The principle laws that govern employment include:

Labor Law of the People's Republic of China, promulgated by the Standing Committee of the National People's Congress on July 5, 1994, effective since January 1, 1995 and amended on August 27, 2009; and

Labor Contract Law of the People's Republic of China, promulgated by the Standing Committee of the National People's Congress on June 29, 2007 and effective since January 1, 2008.

According to the Labor Law and Labor Contract Law, employers must execute written labor contracts with full-time employees. All employers must compensate their employees with wages equal to at least the local minimum wage standards. All employers are required to establish a system for labor safety and sanitation, strictly comply with state rules and standards and provide employees with workplace safety training. Violations of the PRC Labor Contract Law and the PRC Labor Law may result in the imposition of fines and other administrative penalties. For serious violations, criminal liability may arise.

In addition, employers in China are required to provide employees with welfare schemes covering pension insurance, unemployment insurance, maternity insurance, work-related injury insurance, medical insurance and housing funds.

We have caused all of our full-time employees to enter into written labor contracts with us and have provided and currently provide our employees with the proper welfare and employment benefits.

**New M&A Regulations and Overseas Listings**

On August 8, 2006, six PRC governmental agencies jointly promulgated the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, or the New M&A Rule, which became effective on September 8, 2006. The New M&A Rule requires offshore special purpose vehicles formed to pursue overseas listing of equity interests in PRC companies and controlled directly or indirectly by PRC companies or individuals to obtain the approval of the Chinese Securities Regulatory Commission, or the CSRC, prior to the listing and trading of such special purpose vehicle's securities on any stock exchange overseas.

The application of the M&A Rules remains unclear. Based on the understanding on the current PRC laws, rules and regulations and the M&A Rules of our PRC Legal Counsel, Fangda Partners, prior approval from the CSRC is not required under the M&A Rules for the listing and trading of our ADSs on the Nasdaq Global Market because (a) our PRC subsidiaries, Beijing Huanju Shidai, Guangzhou Huanju Shidai and Zhuhai Huanju Shidai, are foreign-invested enterprises established by foreign enterprises, (b) we did not acquire any equity interest or assets of a PRC domestic company owned by PRC companies or individuals as defined under the M&A Rules, and (c) there is no provision that clearly classifies the contractual arrangements among our PRC subsidiary, Beijing Huanju Shidai, our PRC consolidated affiliated entities and their shareholders as a transaction regulated by the M&A Rules. However, as there has been no official interpretation or clarification of the M&A Rules, there is uncertainty as to how this regulation will be interpreted or implemented.

Considering the uncertainties that exist with respect to the issuance of new laws, regulations or interpretation and implementing rules, the opinion of Fangda Partners, summarized above, is subject to change. If the CSRC or another PRC regulatory agency subsequently determines that prior CSRC approval was required, we may face regulatory actions or other sanctions from the CSRC or other PRC regulatory agencies.

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**C. Organizational Structure**

The following diagram illustrates our corporate structure:

- 
- (1) Formerly known as Zhuhai Duowan Technology Company Limited.
  - (2) Formerly known as Duowan Entertainment Information Technology (Beijing) Company Limited.

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- (3) Beijing Tuda is our PRC consolidated affiliated entity. Mr. David Xueling Li, our co-founder, chief executive officer and director, Mr. Tony Bin Zhao, our director and chairman of our technology committee, and Mr. Jin Cao, the general manager of our website department, own 97.7%, 1.5% and 0.8% of Beijing Tuda's equity interests, respectively.
- (4) Guangzhou Huaduo is our PRC consolidated affiliated entity. Mr. Jun Lei, our co-founder and chairman, Mr. David Xueling Li, Mr. Tony Bin Zhao, Mr. Jin Cao and Beijing Tuda own approximately 0.44%, 0.5%, 0.04%, 0.02% and 99.0% of Guangzhou Huaduo's equity interests, respectively.

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**D. Property and Equipment**

Our principal executive offices are located on premises comprising approximately 10,300 square meters in Guangzhou, China. This facility currently accommodates our management headquarters, principal development, engineering, sales and marketing, human resources and administrative activities. The lease for this Guangzhou facility expires in 2015. We also have a branch office in Beijing focusing on research and development, a branch office in Zhuhai focusing on games related businesses, and a representative office in Shanghai that handles advertising-related matters. We lease these relatively small premises under lease agreements from unrelated third parties, and we plan to renew these leases from time to time as needed.

Our servers are hosted in leased internet data centers in different geographic regions in China. The data centers in our network are owned and maintained for us by major domestic internet data center providers. We typically enter into leasing and hosting service agreements that are renewable annually.

We believe that our existing facilities are sufficient for our current needs and we will obtain adequate facilities, principally through leasing, to accommodate our future expansion plans.

See footnotes 9 and 10 to our financial statements for further information about our property and equipment and intangible assets.

**ITEM 4A. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

*You should read the following discussion and analysis of our financial condition and results of operations in conjunction with our consolidated financial statements and the related notes included elsewhere in this annual report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results and the timing of selected events could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under "Risk Factors" and elsewhere in this annual report.*

**A. Operating Results**

**Overview**

We derive our revenues primarily from IVAS and online advertising. We derived 72.7%, 85.7% and 91.0% of our total net revenues from IVAS in 2011, 2012 and 2013, respectively, with online advertising accounting for the remainder of our revenues. Revenues from IVAS are primarily generated through online music and entertainment, online games and other services on our platform. Online advertising revenues are primarily generated from sales of different forms of advertising on Duowan.com and YY Client. We expect to derive an increasing portion of our revenues from IVAS in the future. This trend may pose new challenges to us, including, for example, the need to develop more popular products and services in response to user demand and the need to recruit and retain talented personnel for technology and product development purposes. IVAS revenues depend on the growth of online music and entertainment, the popularity of the online games on our platform and the growth of other types of channels or activities for which IVAS are available.

We began our operations in 2005 by launching Duowan.com, a popular online web portal hosting game media content. We have grown significantly in recent years, developing and introducing YY Client in 2008 and making YY Client available for mobile users through Mobile YY in September 2010. Our total net revenues increased from RMB319.7 million in 2011 to RMB820.0 million in 2012

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and to RMB1,823.5 million (US\$301.2 million) in 2013. We had a net loss of RMB83.2 million in 2011, and in 2012 and 2013, we had a net income of RMB89.2 million and RMB477.7 million (US\$78.9 million), respectively.

**Discussion of Selected Statements of Operations Items****Revenues**

In the years ended December 31, 2011, 2012 and 2013, we had derived our revenues from IVAS and online advertising. Our IVAS revenues are primarily comprised of revenues from the paying users of online music and entertainment, online games and, to a lesser degree, our membership subscriptions and live game broadcasting. Our online advertising revenues primarily consist of revenues from the sale of online advertising in various formats primarily on Duowan.com and YY Client. We expect that in the future, as is the case in 2013, an increasing portion of our revenues will be derived from non-game IVAS revenues, including revenues from in-channel virtual items sold on our platform, such as virtual flowers and gifts for use in various channels, as well as other online products and services.

The following table sets forth the principal components of our total net revenues by amount and as a percentage of our total net revenues for the periods presented.

	For the Year Ended December 31,						
	2011		2012		2013		
	RMB	% of total net revenues	RMB	% of total net revenues	RMB	US\$	% of total net revenues
(in thousands, except for percentages)							
<b>Total net revenues:</b> <sup>(1)</sup>							
IVAS:							
Online music and entertainment	52,854	16.5	286,446	34.9	852,885	140,887	46.8
Online games	165,933	51.9	332,287	40.5	602,111	99,462	33.0
Others	13,589	4.3	83,655	10.2	205,212	33,899	11.2
Online advertising	87,279	27.3	117,643	14.4	163,260	26,969	9.0
<b>Total</b>	<b>319,655</b>	<b>100.0</b>	<b>820,031</b>	<b>100.0</b>	<b>1,823,468</b>	<b>301,217</b>	<b>100.0</b>

(1)

Revenues are presented net of rebates and discounts.

*IVAS revenues.* We generate IVAS revenues from (i) the sales of in-channel virtual items used on our online music and entertainment channels, (ii) the sales of in-game virtual items used for games developed by us or by third parties under revenue-sharing arrangements on our platform and (iii) other revenues, including membership subscription fees and in-channel virtual items used for live game broadcasting. Users access channels and play online games free of charge, but are charged for purchases of virtual items.

The most significant factors that directly affect our IVAS revenues include the increase in the number of our paying users and ARPU:

*The number of paying users.* We had approximately 1.4 million, 2.4 million and 3.2 million paying users in 2011, 2012 and 2013, respectively. We calculate the number of paying users during a given period as the cumulative number of registered user accounts that have purchased virtual items or other products and services on our platform at least once during the relevant period. We were able to achieve an increase in the number of paying users primarily due to a higher conversion ratio of active users to paying users, and we expect that the number of our paying users will continue to grow in the future as we expand our services and products offerings and further monetize our existing platform.

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*ARPU.* Our ARPU for IVAS was approximately RMB164.3, RMB296.5 and RMB525.2 (US\$86.8) in 2011, 2012 and 2013, respectively. ARPU is calculated by dividing our total revenues from IVAS during a given period by the number of paying users for that period. As we begin to generate revenues from an increasing variety of IVAS, our ARPU may fluctuate from period to period due to the mix of IVAS purchased by our paying users.

Other significant factors that directly or indirectly affect our IVAS revenues include:

our ability to increase our popularity by offering new and attractive products and services that allow us to monetize our platform;

our ability to attract and retain a large and engaged user base; and

our ability to attract and retain third party game developers and service providers as well as certain popular performers and channel owners.

We expect that the portion of our revenues from IVAS derived from the sales of non-game virtual items and services will continue to increase as we capitalize on monetization opportunities. We create and offer to users virtual items that can be used on various channels. Users can purchase consumable virtual items from us to show support for their favorite performers or time-based virtual items that provide users with recognized status, such as priority speaking rights or special symbols on the music and entertainment channels. The percentage of our total net revenues attributable to virtual items sold on our online music and entertainment channels increased from 16.5% in 2011 to 34.9% in 2012 and further to 46.8% in 2013.

The online games we currently offer are primarily web games that can be run from an internet browser and require an internet connection to play. We have historically derived a significant portion of our revenues from a limited number of popular online games, primarily through selling in-game virtual items for these games. A majority of our popular online games are developed by third party game developers under revenue-sharing arrangements that typically last one to two years. We derive an increasingly lower percentage of our revenues from online games as a whole, as we expect to monetize other non-game aspects of the YY platform, such as online music and entertainment.

*Online advertising revenues.* We also offer a wide range of online advertising formats and solutions. We enter into advertising contracts with both advertisers and advertising agencies. In 2011, 2012 and 2013, a vast majority of our online advertising revenues were derived from pay-for-time arrangements under which we charge advertisers depending on the duration of display for an advertisement or a series of advertisements.

**Cost of Revenues**

Cost of revenues consists primarily of (i) revenue sharing fees and content costs, (ii) bandwidth costs, (iii) salary and welfare, (iv) business tax and surcharges, (v) depreciation and amortization, (vi) payment handling costs and (vii) share-based compensation. We anticipate that revenue sharing fees and content costs paid to performers, channel owners and content providers will increasingly contribute to our cost of revenues. We expect that our cost of revenues will increase in absolute amount as we further grow our user base and expand our revenue-generating services.

*Revenue sharing fees and content costs.* Our revenue sharing fees and content costs paid to performers, channel owners and content providers increased from RMB6.8 million in 2011 to RMB109.3 million in 2012 and further increased to RMB444.1 million (US\$73.4 million) in 2013. We also incurred a non-recurring cost in 2013 due to our partnership with Hunan Satellite Television Station in the 2013 Happy Boy Show, a popular entertainment show in China. We expect our revenue sharing fees and content costs to increase as we continue to expand our IVAS offerings.

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*Bandwidth costs.* Our bandwidth costs increased from RMB75.1 million in 2011, to RMB145.0 million in 2012 and further increased to RMB203.2 million (US\$33.6 million) in 2013. We expect bandwidth costs to increase as our user base continues to expand and as online music and entertainment and other video-related services become more popular in the future.

*Salary and welfare.* Our salary and welfare costs increased from RMB33.4 million in 2011 to RMB50.0 million in 2012, and further increased to RMB88.5 million (US\$14.6 million) in 2013. We expect our salary and welfare costs to increase as we continue to hire additional employees in line with the expansion of our business.

*Business tax and surcharges.* Our business tax and surcharges increased from RMB16.5 million in 2011 to RMB30.0 million in 2012, and further increased to RMB47.8 million (US\$7.9 million) in 2013.

*Depreciation and amortization.* Our depreciation and amortization increased from RMB12.0 million in 2011 to RMB25.8 million in 2012, and further increased to RMB37.1 million (US\$6.1 million) in 2013. We expect depreciation and amortization to increase as we continue to expand our operations and purchase servers and other equipment or intangibles directly related to the operating of our platform and business.

*Payment handling costs.* Our payment handling costs increased from RMB9.3 million in 2011 to RMB22.8 million in 2012, and further increased to RMB25.0 million (US\$4.1 million) in 2013. We expect payment handling costs to increase as we continue to grow our paying users and expand our paid service offerings.

*Share-based compensation.* Our share-based compensation allocated to the cost of revenues decreased from RMB15.4 million in 2011 to RMB8.4 million in 2012 and then increased to RMB9.9 million (US\$1.6 million) in 2013.

### **Operating Expenses**

Our operating expenses consist of (i) research and development expenses, (ii) sales and marketing expenses and (iii) general and administrative expenses. The following table sets forth the components of our operating expenses for the years indicated, both in absolute amounts and as percentages of our total net revenues. We expect our operating expenses to generally increase in absolute amount and decrease as percentage of total net revenues in the near future.

	<b>For the Year Ended December 31,</b>						
	<b>2011</b>		<b>2012</b>		<b>2013</b>		
	<b>RMB</b>	<b>% of total net revenues</b>	<b>RMB</b>	<b>% of total net revenues</b>	<b>RMB</b>	<b>US\$</b>	<b>% of total net revenues</b>
	<b>(in thousands, except for percentages)</b>						
<b>Operating expenses:</b>							
Research and development expenses	106,804	33.4	176,725	21.6	267,005	44,106	14.6
Sales and marketing expenses	13,381	4.2	16,954	2.1	24,955	4,122	1.4
General and administrative expenses	118,241	37.0	109,788	13.4	200,554	33,129	11.0
<b>Total operating expenses</b>	<b>238,426</b>	<b>74.6</b>	<b>303,467</b>	<b>37.1</b>	<b>492,514</b>	<b>81,357</b>	<b>27.0</b>

### *Research and Development Expenses*

Research and development expenses consist primarily of salaries and benefits for research and development personnel and rental and depreciation of office premise and servers utilized by the research and development personnel. Research and development expenses generally increased in the past three years ended December 31, 2013, due to the need for additional research and development





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personnel to accommodate the rapid growth of our business. We expect our research and development expenses in absolute amount to increase as we intend to retain existing research and development personnel and also hire new ones to, among other things, develop new series of applications for our platform, improve technology infrastructure to further enhance user experience, and further develop enhanced features for Mobile YY to reach more users.

*Sales and Marketing Expenses*

Sales and marketing expenses consist primarily of salaries, benefits and commissions for our sales and marketing personnel, share-based compensation expenses and advertising and promotion expenses. Our sales and marketing expenses generally increased over the past three years ended December 31, 2013, primarily reflecting increased promotional activities and increased commissions for our sales and marketing personnel as our advertising revenues increased. We expect that our sales and marketing expenses will increase in absolute amount in the near term as we expect to increase our spending on promotional activities.

*General and Administrative Expenses*

General and administrative expenses consist primarily of salaries and benefits, including share-based compensation for our general and administrative personnel, allowance for doubtful receivables, professional service fees, legal expenses and other administrative expenses. Our general and administrative expenses generally increased over the past three years ended December 31, 2013 as our business expanded, primarily due to the hiring of additional management and administrative staff and increase in share-based compensation expenses. We expect our general and administrative expenses to increase in the future as our business grows.

*Share-based Compensation Expenses*

Our operating expenses include share-based compensation expenses as follows:

	For the Year Ended December 31			
	2011	2012	2013	
	RMB	RMB	RMB	US\$
	(in thousands)			
Research and development expenses	31,672	35,441	39,587	6,539
Sales and marketing expenses	1,336	884	1,318	218
General and administrative expenses	86,544	55,619	66,331	10,957
 Total	 119,552	 91,944	 107,236	 17,714

We grant stock-based award such as, but not limited to, share options, restricted shares, restricted share units and warrants to eligible employees, officers, directors, and non-employee consultants. Awards granted to employees, officers, and directors are initially accounted for as equity-classified awards, which are measured at the grant date fair value of the award and are recognized using the graded vesting method, net of estimated forfeitures, over the requisite service period, which is generally the vesting period. Awards granted to non-employees are initially measured at fair value on the grant date and periodically re-measured thereafter until the earlier of the performance commitment date or the date the service is completed and recognized over the period in which the service is provided.

As a result of repurchases of certain awards offered in 2009 and in 2011, certain initially equity-classified employee and non-employee awards have been reclassified as liability-classified awards, as these awards were deemed to have a substantive cash settlement feature. These awards are re-measured at the end of each reporting period until either the substantive cash settlement is terminated or the holder of the awards is exposed to the market value fluctuation of the underlying

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shares for a reasonable period of time (at least six months), or the awards are settled, cancelled or expire unexercised.

On September 15, 2011, our board of directors resolved not to undertake any repurchases of vested or unvested share-based compensation awards, except under those conditions specified in the relevant award scheme and grant documents. Accordingly, the classification of the liability-classified awards was changed to being equity-classified, and the related liability was reclassified as additional paid-in capital on the modification date. After the awards were changed to equity-classified awards, they were measured based on the fair value of the awards on September 15, 2011, and the expenses to be recognized over the remaining requisite service period are calculated using the graded vesting attribution method.

**Taxation**

*Cayman Islands*

According to our Cayman Islands counsel, Conyers Dill & Pearman (Cayman) Limited, Cayman Islands currently levies no taxes on individuals or corporations based upon profits, income, gains or appreciations and there is no taxation in the nature of inheritance tax or estate duty. There are no other taxes likely to be material to us levied by the government of the Cayman Islands except for stamp duties which may be applicable on instruments executed in, or after execution brought within the jurisdiction of, the Cayman Islands. There are no exchange control regulations or currency restrictions in the Cayman Islands.

Pursuant to Section 6 of the Tax Concessions Law (1999 Revision) of the Cayman Islands, we have obtained an undertaking from the Governor-in-Cabinet:

- (1) that no law which is enacted in the Cayman Islands imposing any tax to be levied on profits or income or gains or appreciations shall apply to us or our operations; and
- (2) that the aforesaid tax or any tax in the nature of estate duty or inheritance tax shall not be payable on our shares, debentures or other obligations.

The undertaking is for a period of twenty years from August 2, 2011.

*British Virgin Islands*

Duowan BVI is our wholly owned subsidiary.

As Duowan BVI is a BVI business company subject to the provisions of the BVI Business Companies Act 2004 (as amended), it is exempt from all provisions of the Income Tax Act of the BVI (including with respect to all dividends, interests, rents, royalties, compensation and other amounts payable by Duowan BVI to persons who are not persons resident in the BVI).

Capital gains realized with respect to any shares, debt obligations or other securities of a company by persons who are not persons resident in the BVI are also exempt from all provisions of the Income Tax Act of the BVI.

No estate, inheritance, succession or gift tax, rate, duty, levy or other charge is payable by persons who are not persons resident in the BVI with respect to any shares, debt obligations or other securities of Duowan BVI, save for interest payable to or for the benefit of an individual resident in the European Union.

*Hong Kong*

The Company's subsidiary registered in Hong Kong is subject to Hong Kong Profits Tax on the taxable income as reported in its respective statutory financial statements adjusted in accordance with relevant Hong Kong tax laws. The applicable tax rate is 16.5% in Hong Kong.

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*PRC*

Current taxation primarily represented the provision for a state and local corporate income tax, or EIT, for subsidiaries and consolidated affiliated entities operating in the PRC. Prior to January 1, 2008, companies established in the PRC were generally subject to EIT at statutory rates of 30% and 3% respectively. On March 16, 2007, the PRC National People's Congress promulgated the New EIT Law, which became effective on January 1, 2008. These subsidiaries and VIEs are subject to new EIT on their taxable income as reported in their respective statutory financial statements adjusted in accordance with the relevant tax laws and regulations in the PRC. All our PRC entities are subject to EIT at a rate of 25%, with the exception of any preferential treatments they may receive, such as the 15% preferential tax rate that Guangzhou Huaduo can enjoy for the periods reported as a result of its qualification as a high and new technology enterprise. Furthermore, Guangzhou Huanju Shidai has been qualified as a software enterprise since 2013, and is entitled to a two-year exemption from EIT followed by three years at 50% tax reduction starting from the first profit-making year.

According to a policy promulgated by the state tax bureau of the PRC and effective from 2008 onwards, enterprises engaged in research and development activities are entitled to claim 150% of the research and development expenses so incurred in a year as tax deductible expenses in determining its tax assessable profits for that year, or Super Deduction. Guangzhou Huaduo and Zhuhai Duowan have claimed such Super Deduction for the periods reported. In addition, Guangzhou Huanju Shidai and Beijing Huanju Shidai started to claim such Super Deduction since 2013.

In addition, according to the New EIT Law and its implementation rules, foreign enterprises, which have no establishment or place in the PRC but derive dividends, interest, rents, royalties and other income (including capital gains) from sources in the PRC is subject to PRC withholding tax, or WHT, at 10% (a further reduced WHT rate may be available according to the applicable double tax treaty or arrangement). The 10% WHT is applicable to any dividends to be distributed from our PRC subsidiaries and consolidated affiliated entities to us and our subsidiaries outside the PRC. We do not have any present plan to pay out the retained earnings in the PRC subsidiaries and PRC consolidated affiliated entities in the foreseeable future. We currently intend to retain our available funds and any future earnings to operate and expand our business. Accordingly, no such WHT has been accrued.

Our PRC subsidiaries and PRC consolidated affiliated entities are subject to business taxes or value added tax and related surcharges. On January 1, 2012, the State Administration of Taxation officially launched a pilot value added tax reform program, or Pilot Program, applicable to businesses in selected industries. Taxable income derived from the businesses in the Pilot Program is subject to value added tax in lieu of business tax. Prior to the Pilot Program, revenues from IVAS and advertising revenues were subject to business tax at rates of 3% and 5%, respectively. After the launch of Pilot Program, revenues from IVAS are subject to 3% business tax except that online game revenues are subject to 6% VAT, while advertising revenues are subject to 6% VAT. Surcharges are calculated based on 12% of the monthly business taxes and VAT payable for 2011, 2012 and 2013. Business taxes and related surcharges during 2011, 2012 and 2013 were RMB16.5 million, RMB30.0 million and RMB47.8 million (US\$7.9 million), respectively.

For more information on PRC tax regulations, see "PRC Regulation Regulation on Tax."

**Critical Accounting Policies**

We prepare our financial statements in conformity with U.S. GAAP, which requires us to make estimates and assumptions that affect our reporting of, among other things, assets and liabilities, revenues and expenses. We regularly evaluate these estimates and assumptions based on the most recently available information, our own historical experiences and other factors that we believe to be relevant under the circumstances. Since our financial reporting process inherently relies on the use of estimates and assumptions, our actual results could differ from these estimates. This is especially true

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with some accounting policies that require higher degrees of judgment than others in their application. We consider the policies discussed below to be critical to an understanding of our audited consolidated financial statements because they involve the greatest reliance on our management's judgment.

***Revenue Recognition and Deferred Revenue***

We generate revenues from IVAS and online advertising. Revenues from IVAS are generated based on the revenue-sharing with game developers for direct purchase and conversion of game tokens, sales of virtual items in online games, online music and entertainment and other channels, and membership subscription fees, as well as other IVAS. Online advertising revenues are primarily generated from sales of different forms of advertising on Duowan.com and YY Client. Revenue is recognized when persuasive evidence of an arrangement exists, service has been rendered, the price is fixed or determinable and collection is reasonably assured. Revenue is deferred until these criteria are met as describe below.

***IVAS***

We offer our IVAS on our platform, including online music and entertainment, online games and membership. Users can play online games and participate in our online music and entertainment through our platform free of charge, but they are charged when they purchase virtual items. In addition, users who subscribe to our membership program pay monthly fees in order to enjoy certain functions and privileges unavailable to other users. We operate a virtual currency system under which our users can directly purchase our virtual currency, game tokens and virtual items on our platform's online community channels or pay membership subscription fees via third-party payment systems, including payments using mobile phones and internet debit/credit card payments. Our virtual currency can be used to (a) convert into game tokens that can be used to purchase virtual items in online games, (b) purchase virtual items in channels on our platform, or (c) pay membership subscription fees. Virtual currency sold but not yet consumed by the users is recorded as "advances from users" and, upon being converted or used, is recognized as revenue according to the respective prescribed revenue recognition policies addressed below:

***Online music and entertainment revenue***

We create and offer virtual items to be used by users on our online music and entertainment channels that we operate and maintain. The virtual items are offered free of charge or at different specified prices. Online music and entertainment revenue consists of sales of virtual items. Users purchase consumable virtual items from us and present them to performers to show support for their favorite performers or time-based virtual items which provide users with recognized status, such as priority speaking rights or special symbols on the music channels for a specific period of time. In order to attract user traffic, we share a portion of the revenues we derive from such in-channel virtual item sales on online music and entertainment channels with certain popular performers and channel owners, who have entered into revenue sharing arrangements with us. We account for such shared revenues as cost of revenues. Performers and channel owners who do not have such revenue sharing arrangements with us are not entitled to share any revenue derived from the virtual items sold. We do not recognize any revenue from offering free virtual items and do not share any revenue with performers or channel owners when free virtual items are presented to performers by our users. Accordingly, online music and entertainment revenue is recognized for the sale of virtual items sold in online music and entertainment channels immediately if the virtual item is a consumable or, in the case of time-based virtual items, recognized ratably over the period each virtual item is made available to the user, which does not exceed one year. We do not have further obligations to the user after the virtual items are consumed. Virtual items may be sold individually or bundled into one arrangement. When our users purchase multiple virtual items bundled within the same arrangement, we evaluate such arrangements

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under ASC 605-25 *Multiple-Element Arrangements*. We identify individual elements under the arrangement and determine if such elements meet the criteria to be accounted for as separate units of accounting. We allocate the arrangement consideration to separate units of accounting based on their relative selling price. The following hierarchy has been followed when determining the relative selling price for each element: (1) vendor specific objective evidence, or VSOE, (2) third party evidence, or TPE, and (3) best estimate of selling price, or BESP. Given that the VSOE of the selling price cannot be determined, we have adopted a policy to allocate the consideration of the whole arrangement to different virtual item elements based on the TPE of selling price or the BESP for each virtual item element. We determine the fair values of virtual items sold in a bundle based on similar products sold separately on the YY platform based on the TPE of selling price and determine the fair values of virtual items without similar products sold separately on the YY platform based on the BESP. The BESP is generally based on the selling prices of the various elements of a similar nature when they are sold to users on a stand-alone basis. The BESP may also be based on the estimated stand-alone pricing when the element has not previously been sold on a stand-alone basis. These estimates are generally determined based on pricing strategies, market factors and strategic objectives. We recognize revenue for each virtual item element in accordance with the applicable revenue recognition method.

*Online game revenue*

Users play online games on our website free of charge, but they are charged for purchases of in-game virtual items including consumable and perpetual items, which can be utilized in the online games to enhance their game-playing experience. Currently, these online games on our platform that contribute to IVAS revenues are primarily web games. Consumable items represent virtual items that can be consumed by a specific user within a specified period of time. Perpetual items represent virtual items that are accessible to the user's account over the life of the online games.

We recognize revenues when recognition criteria defined under U.S. GAAP are satisfied. For purposes of determining when the service has been provided, we have determined that there is an implied obligation from us to the paying user to continue providing access to the games such that the users can utilize the virtual items purchased by game tokens. Game players need to log on and access the games through our platform because their virtual currency, game tokens, virtual items, and game history are specific to our game accounts and are non-transferable to other platforms. To purchase in-game virtual items, our users can either charge their game accounts by purchasing game tokens, or virtual currency from our platform, which are convertible into game tokens based on a predetermined exchange rate agreed among us and the relevant game developers.

The proceeds from the purchase of our virtual currency is recorded as an "advance from customers," representing prepayments received from users in the form of our virtual currency but not yet converted into game specific tokens. Upon the conversion into a game token from our virtual currency or upon the direct purchase of a game token, whichever is applicable, the proceeds will be shared between us and the relevant game developer based on a predetermined contractual ratio. Game tokens are non-refundable and non-exchangeable among different games. Our portion, net of the game developer's entitled consideration, is recorded as deferred revenue and amortized according to the prescribed revenue recognition policies described below. Users typically do not convert our virtual currency into game tokens or purchase game tokens unless they plan to purchase in-game virtual items shortly thereafter.

We generate revenues from offering online games developed by both third parties and by ourselves. The majority of online game revenues have been derived from third party developed games.

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Third party developed games

Pursuant to contracts signed between us and the respective game developers, revenues from the sale or conversion of game tokens to be used for the purchase of in-game virtual items derived from online games developed by third parties are shared between us and the game developers based on a pre-agreed ratio for each game. These revenue-sharing arrangements typically last for a range of one year to two years.

The third party developed games under non-exclusive licensing contracts are maintained and updated by the game developers. We mainly engage in certain standard promotional activities that include providing access to the platform, announcing new games to users on the platform, and occasionally advertising on the YY platform. The determination of whether to record these revenues using gross or net method is based on an assessment of various factors. The primary factors are whether we act as the principal in offering services to the game players or as agent in the transaction, and the specific requirements of each contract. We determined that for third party developed games, the third party game developers are the principal given that the game developers design and develop the game services offered, have reasonable latitude to establish prices of game tokens, and are responsible for maintaining and upgrading the game content and virtual items. Accordingly, we record online game revenue, net of the pre-agreed portion of revenue attributable to the game developers.

Given that third party developed games are managed and administered by the third party game developers, we do not have access to the data on the consumption details such as when a game token is spent on the virtual items or the types of virtual items (consumable or perpetual items) purchased by each individual game player. However, we maintain historical data on the timing of the conversion of our virtual currency into game-specific tokens and the amount of game tokens purchased. We believe that our performance for, and obligation to, the game developers correspond to the game developers' services to the users. We have adopted a policy to recognize revenues relating to game tokens for third party developed games over the estimated user relationship with us on a game-by-game basis, which are approximately one to six months for the periods presented. Future usage patterns may differ from historical usage patterns and therefore the estimated user relationship with us may change in the future.

When we launch a new game, we estimate the user relationship based on other similar types of games in the market until the new game establishes its own history. We also consider the game's profile, attributes, target audience, and its appeal to players of different demographic groups in estimating the user relationship period.

The consideration of user relationship with each online game is based on our best estimate that takes into account all known and relevant information at the time of assessment. We assess the estimated user relationships on a quarterly basis. Any adjustments arising from changes in user relationship as a result of new information will be accounted as a change in accounting estimate in accordance with ASC 250 Accounting Changes and Error Corrections.

Self-developed games

Revenues derived from our self-developed games are recorded on a gross basis as we act as a principal to fulfill all obligations. We do not maintain information on consumption details of in-game virtual items, and only have limited information related to the frequency of log-ons for our two self-developed games. Given that certain historical data is not available, we use the user relationship of third party games with similar popularity, gaming experience and sales to determine the estimated period of the user relationship for our self-developed games.

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*Other IVAS revenue*

Other IVAS revenue mainly represents revenue from membership subscription fees and revenue from the sale of other items on the YY platform. We launched our membership program where subscription members can have enhanced user privileges when using YY Client. The membership fee is collected up-front from each subscriber. The receipt of the revenue is initially recorded as deferred revenue, and revenue is recognized ratably over the period the subscription services are rendered. Unrecognized portion beyond 12 months from the balance sheet date is classified as long-term deferred revenue.

Revenue from sales of virtual items in various channels is recognized on item basis, which is consistent with the revenue recognition policies in our online music and entertainment revenue stream.

*Advertising revenues*

Advertising revenues are derived principally from advertising arrangements where the advertisers pay to place their advertisements on Duowan.com and YY Client in different formats over a particular period of time. Such formats generally include but are not limited to banners, text-links, videos, logos, and buttons. Advertisements on our platform are generally charged on the basis of duration, and advertising contracts are signed to establish the fixed price and the advertising services to be provided. Where collectability is reasonably assured, advertising revenues from advertising contracts are recognized ratably over the contract period of display.

We enter into advertising contracts directly with advertisers or third party advertising agencies that represent advertisers. A typical contract term would range from one to three months. Both third party advertising agencies and direct advertisers are generally billed at the end of the display period and payments are due usually within six months.

Where our customers purchase multiple advertising spaces with different display periods in the same contract, we allocate the total consideration to the various advertising elements based on relative selling price method and recognize revenue for the different elements over their respective display periods. We determine the fair values of different advertising elements based on our best estimate of selling prices of each advertisement within the contract, taking into consideration our standard price list and historical discounts granted. We recognize revenue on the elements delivered and defer the recognition of revenue for the fair value of the undelivered elements until the remaining obligations have been satisfied. Where all of the elements within an arrangement are delivered uniformly over the agreement period, the revenues are recognized on a straight line basis over the contract period.

Transactions with third party advertising agencies

For contracts entered into with third party advertising agencies, the third party advertising agencies will in turn sell the advertising services to advertisers. Revenue is recognized ratably over the contractual period of display based on the following criteria:

there is persuasive evidence that an arrangement exists we enter into framework and execution agreements with the advertising agencies, specifying price, advertising content, format and timing;

price is fixed or determinable the price charged to the advertising agencies are specified in the agreements, including relevant discount and rebate rates;

services are rendered we recognize revenue ratably as the elements are delivered over the contract period of display; and

collectability is reasonably assured we assess the credit history of each advertising agency before entering into any framework and execution agreements. If the collectability from the



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agencies is assessed is not reasonably assured, we recognize revenue only when the cash is received and all the other revenue criteria are met.

We provide sales incentives in the forms of discounts and rebates to third party advertising agencies based on purchase volume. As the advertising agencies are viewed as the customers in these transactions, revenue is recognized based on the price charged to the agencies, net of sales incentives provided to the agencies. Sales incentives are estimated and recorded at the time of revenue recognition based on the contracted rebate rates and estimated sales volume based on historical experience.

Transactions with advertisers

We also enter into advertisement contracts directly with advertisers. Under these contracts, similar to transactions with third party advertising agencies, we recognize revenue ratably as the elements are delivered over the contractual periods of display. The terms and conditions, including price, are fixed according to the relevant advertising contract. We also perform a credit assessment of all advertisers prior to entering into contracts. Revenue is recognized based on the amount charged to the advertisers, net of discounts.

*Advances from customers and deferred revenue*

Advances from customers primarily consist of (i) prepayments from users in the form of our virtual currency that are not yet consumed or converted into game tokens, and upon the consumption or conversion, are recognized as revenue according to the prescribed revenue recognition policies described above, (ii) prepayments from sub-licensees for obtaining operation rights of certain online games over a period of time, and (iii) prepayments from advertising agencies and advertisers. Deferred revenue primarily consists of the unamortized revenue from game tokens, prepaid subscriptions under the membership program and unamortized revenue from virtual items in our online music and entertainment channels, where there is still an implied obligation to be provided by us which will be recognized as revenue when all of the revenue recognition criteria are met.

*Accounts receivable, net*

Accounts receivable are presented net of allowance for doubtful accounts. We use specific identification in providing for bad debts when facts and circumstances indicate that collection is doubtful and a loss is probable and estimable. If the financial condition of its customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowance would be required.

We review on a periodic basis for doubtful accounts based on historical experience and information available. Additionally, we make specific bad debt provisions based on (i) our specific assessment of the collectability of all significant accounts; and (ii) any specific knowledge we have acquired that might indicate that an account is uncollectible. The facts and circumstances of each account may require us to use substantial judgment in assessing its collectability.

***Consolidation***

Our consolidated financial statements include the financial statements of our company, our subsidiaries, variable interest entities ("VIEs") and VIE's subsidiary for which we or our subsidiaries are the primary beneficiaries. All transactions and balances among our company, subsidiaries, VIEs and VIE's subsidiary have been eliminated upon consolidation.

A subsidiary is an entity in which our company, directly or indirectly, controls more than one half of the voting power, has the power to appoint or remove the majority of the members of the board of

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directors or to cast a majority vote at each meeting of directors, or has the power to govern the financial and operating policies of the investee under a statute or agreement among the entity's shareholders or equity holders.

A VIE is an entity in which our company, or one of our subsidiaries, through contractual agreements, bears the risks of, and enjoys the rewards normally associated with ownership of the entity, and therefore our company or one of our subsidiaries is the primary beneficiary of the entity. In determining whether our company or our subsidiaries are the primary beneficiary, we considered whether we have the power to direct activities that are significant to the VIE's economic performance, and also our obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Foreign ownership of internet-based businesses is subject to significant restrictions under current PRC laws and regulations. We conduct our operations in China primarily through a series of contractual arrangements entered into among Beijing Huanju Shidai, our PRC subsidiary, Guangzhou Huaduo and Beijing Tuda, as well as Guangzhou Huaduo and Beijing Tuda's shareholders. Based on our evaluations of the relationships between us and Beijing Tuda and Guangzhou Huaduo, the economic benefit flow of contractual arrangements made with them, as well as the controls conferred to us through these contractual arrangements enacted, we consider, through Beijing Huanju Shidai, we exercise effective control over Guangzhou Huaduo and Beijing Tuda, receive substantially all of their economic benefits and residual returns, and absorb substantially all the risks and expected losses from these two companies as if we were their sole shareholder. We also have an exclusive option to purchase all of the equity interests in each of Beijing Tuda and Guangzhou Huaduo when and if PRC law permits so and also the exclusive right to require any nominee shareholder of Beijing Tuda or Guangzhou Huaduo to transfer its interest in them to any person designated by us. For a detailed description of these contractual arrangements, see "Item 7. Major Shareholders and Related Party Transactions B. Related Party Contractual Arrangements with Beijing Tuda." Based on our evaluation, we consider each of Beijing Tuda and Guangzhou Huaduo to be our VIE. Beijing Huanju Shidai, our wholly owned subsidiary in China, is the primary beneficiary of our VIEs; therefore, we consolidate the results of Beijing Tuda and Guangzhou Huaduo in our consolidated financial statements under U.S. GAAP.

As advised by our PRC counsel, Fangda Partners, the contractual arrangements among Beijing Huanju Shidai and Beijing Tuda and its shareholders and the contractual arrangements among Beijing Huanju Shidai and Guangzhou Huaduo and its shareholders, governed by PRC law, are valid, binding and enforceable, and do not violate PRC laws currently in effect. However, if such contracts are held to be unenforceable, or if there are changes in PRC laws and regulations that affect our ability to control Beijing Tuda and Guangzhou Huaduo, we may be precluded from consolidating these companies in the future.

***Share-based compensation***

We awarded a number of share-based compensation to our employees and non-employees (such as consultants), which include share options, restricted shares and restricted share units granted to employees and non-employees, share-based awards granted to our chief executive officer and chairman and share-based awards granted in relation to our acquisition of NeoTasks Inc. The details of these share-based awards and the respective terms and conditions are described in "Share-based compensation" in Note 19 to our audited consolidated financial statements for the years ended December 31, 2011, 2012 and 2013, which are included elsewhere in this annual report on Form 20-F.

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*Share options*

Options were initially accounted for as equity-classified awards because there are no explicit repurchase rights specified in the award documents and the number of shares of our common shares issued under these awards are fixed and determined at the time of grants. All options to employees and non-employees are measured based on the grant date fair value of the award and recognized as compensation expense based on the graded-vesting method, net of estimated forfeitures, over the requisite service period, with a corresponding impact reflected in additional paid-in capital. The options to non-employees are re-measured at each reporting date using the fair value as at each period end. The compensation expense is recognized using the graded-vesting method.

Nevertheless, a number of our outstanding employee share-based awards relating to stock options granted to employees and non-employees, or the Pre-2009 Scheme Options, prior to the adoption of our 2009 Scheme had been subject to past practices of repurchases in conjunction with our preferred shares and common share issuance made to our shareholders and investors, details of which are described in "Share-based compensation" in Note 19 to our audited consolidated financial statements which are included elsewhere in this annual report.

Upon the negotiation and occurrence of our repurchase of certain outstanding share-based awards in November 2009, the details of which are set out in "Share-based compensation" in Note 19 to our audited consolidated financial statements which are included elsewhere in this annual report, we considered it probable for holders of the Pre-2009 Scheme Options to develop an expectation that we might continue to repurchase their vested options in the future. As a result, such past practices result in a constructive obligation of ours. Such initially equity-classified awards were considered to have been tainted and they began to be reflected as a stock compensation liability on our consolidated balance sheets, commencing on the date when the definitive agreement on the repurchase was reached with the respective holders of the instruments in 2009. In the case of any future repurchases, the repurchase price of these awards would be determined by our board of directors with reference to valuation results regarding the fair value of our common shares prevailing at the time of repurchase and therefore it was not determinable until the date of repurchase.

We continued to amortize share-based compensation expenses for those awards expected to vest on a graded-vesting basis over the requisite service period. We re-measured the fair value of the awards at the end of each reporting period until either the repurchase rights were exercised or the holders were exposed to the market value of the shares for a reasonable period of time of at least six months, or the awards were settled, cancelled or expire unexercised.

On September 15, 2011, we determined not to undertake any repurchases of vested or unvested share-based compensation awards, except under those conditions specified in the relevant award scheme and grant documents. In addition, any proposed repurchase of vested or unvested share-based compensation awards should be approved by the majority votes of the board of directors. Our intention was specifically communicated to all employees. All employees with vested or unvested awards also confirmed their understanding and agreement through written confirmation. Accordingly, the classification of the liability-classified awards was changed to become equity-classified.

We engaged an independent valuation firm to assist us in our determination of the fair value of our share options as of each grant date and each re-measurement date. However, our management is ultimately responsible for such determination.

In determining the value of share options, we have used the binomial option pricing model to determine the fair value of equity-classified awards on grant dates and liability-classified awards on re-measurement dates. Under this option pricing model, certain assumptions are required. Changes in these assumptions could significantly affect the fair value of share options and hence the amount of compensation expense we recognized in our consolidated financial statements.

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The key assumptions used in valuation of the options for re-measurement date fair values in 2011 are summarized in the following table:

	RMB
Risk-free interest rate <sup>(1)</sup>	3.34%-4.01%
Exercise multiple <sup>(2)</sup> (times)	2.2
Expected term <sup>(3)</sup> (years)	6-8
Expected volatility <sup>(4)</sup>	53.06%-55.34%
Expected dividend yield <sup>(5)</sup>	

- (1) The risk-free interest rate of periods within the contractual life of the share option is based on the China Government Bond yield as at the valuation dates.
- (2) The exercise-multiple is an assumption about early exercise behavior or patterns based on stock-price appreciation rather than the time that has elapsed since the grant date. It represents the expected ratio of stock price to exercise price at the time of exercise.
- (3) The expected term is the remaining contract life of the option.
- (4) Expected volatility is estimated based on the average of historical volatilities of the comparable companies in the same industry as at the valuation dates.
- (5) Neither Duowan BVI nor our company has a history or the expectation of paying dividends on its common shares. The expected dividend yield was estimated based on our expected dividend policy over the expected term of the option.

Upon the completion of the initial public offering, the share options granted to a non-employee were remeasured at the stock price of our common share. All share options granted to the non-employee were exercised in 2013.

#### *Share-based award for our acquisition of NeoTasks*

In December 2008, in connection with the acquisition of NeoTasks, we issued warrants to purchase 17,915,380 common shares and 8,957,690 common shares of our company to two founders of NeoTasks with a service condition of three years. In October 2009, our board approved the request of these warrant holders to exercise their warrants to acquire 26,873,070 restricted shares that were subject to a restricted share agreement with the same rights and vesting conditions as the original warrant grants.

These share-based awards were initially accounted for as equity-classified awards because there are no explicit repurchase rights specified in the award documents and the number of shares of our common shares issued under these awards are fixed and determined at the time of grants.

We recognize the value of the portion of the warrants/restricted shares that we ultimately expect to vest as expense over the requisite service periods in our consolidated statements of operations on a graded-vesting basis.

However, a number of our outstanding warrants/restricted shares had been subject to practices of repurchases in conjunction with our preferred share and common share issuance made to our shareholders and investors, details of which are described in "Share-based compensation" in Note 19 to our audited consolidated financial statements which are included elsewhere in this annual report.

Upon the negotiation and occurrence of the latest repurchase of outstanding share-based awards in 2009, we considered that it is probable that holders may develop an expectation that we might continue to repurchase their vested warrants in the future. As a result, such past practices result in a constructive obligation of ours. Such initially equity-classified awards were considered to have been tainted and they began to be reflected as a stock compensation liability on our consolidated balance sheet, commencing on the date when the definitive agreement on the First Repurchase was reached with the respective holders of the instruments.



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We continued to amortize share-based compensation expense for those awards expected to vest on a graded-vesting basis over the requisite service period. We re-measured the fair value of the awards at the end of each reporting period until either the repurchase rights are exercised or the holders are exposed to the market value of the shares for a reasonable period of time (at least six months), or the awards are settled, cancelled or expire unexercised.

The fair value of warrants/restricted shares was based on the fair value of our underlying common shares on the grant date and re-measurement date.

The restricted shares granted to NeoTasks had been fully vested as of December 31, 2011.

*Restricted shares*

Restricted shares issued to our employees are measured based on the grant date fair value of the award and recognized as compensation expense based on the graded-vesting method, net of estimated forfeitures, over the requisite service period, with a corresponding impact reflected in additional paid-in capital. The fair value of restricted shares was based on the fair value of our underlying common shares on the grant date.

We account for restricted shares issued to non-employees are measured at fair value at the date the services are completed. These awards are re-measured at each reporting date using the fair value as at each period end until the measurement date. The compensation expenses is recognized using the graded vesting method.

We are required to estimate forfeiture at the time of grant and revise those estimated in subsequent periods if actual forfeitures differ from those estimates. Historical data was used to estimate pre-vesting forfeitures and record share-based compensation expenses only for those awards that we expect to vest.

The following table sets forth certain information regarding the restricted shares granted to our employees and non-employees at different dates.

<b>Grant Date</b>	<b>Restricted Shares Granted</b>	<b>Fair Value Per Common Share as of the Grant Date (US\$)</b>	<b>Type/Methodology of Valuation</b>
January 1, 2010	23,686,542	0.1590	Retrospective/ GTM(1)
February 1, 2010	4,257,335	0.1875	Retrospective/ GTM(1)
April 1, 2010	2,000,000	0.2721	Retrospective/ GTM(1)
July 1, 2010	20,060,000	0.4666	Retrospective/ GTM(1)
October 1, 2010	500,000	0.6988	Retrospective/ GTM(1)
January 1, 2011	10,846,800	0.9362	Retrospective/ Backsolve(2)

(1) GTM denotes the guideline transaction method under the market approach based on the enterprise value to revenue multiples of our own equity transactions close to the valuation date.

(2) Backsolve denotes the back solve method under the market approach based on our own equity transactions as of the valuation date.

*Restricted share units*

Restricted share units issued to our employees are measured based on the grant date fair value of the award and recognized as compensation expense based on the graded-vesting method, net of estimated forfeitures, over the requisite service period, with a corresponding impact reflected in additional paid-in capital. The fair value of restricted shares was based on the fair value of our underlying common shares on the grant date.

We are required to estimate forfeiture at the time of grant and to revise those estimates in subsequent periods if actual forfeitures differ with those estimates. Historical data was used to estimate



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pre-vesting forfeitures and record share-based compensation expenses only for those awards that we expect to vest.

The following table sets forth certain information regarding the restricted share units granted to our employees in 2011, 2012 and 2013 with share and per share information.

Grant Date	Restricted Shares Units Granted	Fair Value Per Common Share as of the Grant Date (US\$)	Type/Methodology of Valuation
September 16, 2011	9,097,000	1.0630	Contemporaneous/ DCF(1)
January 1, 2012	1,668,000	1.0869	Contemporaneous/ DCF(1)
March 31, 2012	6,597,921	1.1153	Contemporaneous/ DCF(1)
July 15, 2012	533,000	1.1284	Contemporaneous/ DCF(1)
September 1, 2012	6,151,300	1.1146	Contemporaneous/ DCF(1)
September 30, 2012	650,000	1.1437	Contemporaneous/ DCF(1)
November 7, 2012	195,000	0.5250	Contemporaneous/ Stock price(2)
November 21, 2012	2,500,000	0.5250	Contemporaneous/ Stock price(2)
March 31, 2013	1,009,000	0.8450	Contemporaneous/ Stock price(2)
April 18, 2013	43,489	0.7855	Contemporaneous/ Stock price(2)
April 30, 2013	26,943,500	0.8720	Contemporaneous/ Stock price(2)
May 23, 2013	120,000	1.2065	Contemporaneous/ Stock price(2)
July 19, 2013	1,802,000	1.8090	Contemporaneous/ Stock price(2)
October 1, 2013	50,000	2.4045	Contemporaneous/ Stock price(2)
November 1, 2013	48,000	2.4875	Contemporaneous/ Stock price(2)

(1) DCF denotes the discounted cash flow method under the income approach which explicitly recognizes that the business enterprise value as of the valuation date is developed by discounting future net cash flow to the present value at a rate that reflects both the current return requirements of the market and the risks inherent in the specific investment.

(2) Upon the completion of the initial public offering, the fair values of restricted share units are based on stock price of our company on grant dates. The fair values of restricted share units granted on November 7, 2012 are based on initial public offering price as the grant date is close to the initial public offering date.

#### *Share-based awards granted to chief executive officer and chairman*

On February 23, 2010, Mr. David Xueling Li and Mr. Jun Lei, our co-founder, chairman and director, were granted 13,369,813 and 29,678,483 restricted shares, which vested immediately and over a four-year period (50% after the second anniversary and 25% each year thereafter), respectively. These restricted shares are subject to a performance condition which relates to the number of peak concurrent users on YY Client. Such performance condition was met as of December 31, 2010.

We recognized these awards as employee share-based compensation Awards using fair value of the awards on the grant date. The compensation expense for the restricted shares held by Mr. David Xueling Li was fully recognized and the compensation expense for the restricted shares held by Mr. Jun Lei was recognized over the requisite service period using the graded vesting method. Upon the completion of the initial public offering, defined as an "Accelerated Event", the restricted shares granted to the Chairman was fully vested and all remaining compensation expenses were recognized immediately.



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The fair value of the share-based awards above was determined at the respective grant dates by us with the assistance of an independent valuation company.

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*Common share value*

Given that we issued common shares and warrants to Tiger, an independent investor, in January 2011, we used the Backsolve Method based on our own share transactions to determine the fair value of our equity as of January 1, 2011. Among the valuation methodologies, the Backsolve Method is the most objective indicator of the enterprise value at the development stage like our company in January 2011. In view of the fast growing number of registered user accounts, with relatively fixed staff costs and network expenses, we judged it is reasonable to assume that our business enterprise value would increase in line with our growing revenue. For valuation dates in 2010, as there was no share transactions with investor in 2010, we could not adopt the Backsolve Method. Instead, we adopted the Guideline Transaction Method under the market approach and applied the implied business enterprise value to revenue multiples based on the increase in the business enterprise value between our series C financing in November 2009 and the warrants issued to Tiger in January 2011 over the increase in corresponding 12-month trailing revenues, to determine the fair value of our equity in 2010. The income approach discounted cash flow method, or DCF was also used in preparing a business enterprise value analysis of our company as of January 1, 2008, September 16, 2011, January 1, 2012, March 31, 2012, June 1, 2012, July 15, 2012, September 1, 2012 and September 30, 2012 and for the beneficial conversion feature assessments as of June 1, 2008, August 1, 2008 and November 1, 2009.

The determination of the fair value of our common shares requires complex and subjective judgments to be made regarding our projected financial and operating results, our unique business risks, the liquidity of our shares and our operating history and prospects at the time of each grant. Had our management used different assumptions and estimates, the resulting fair value of our common shares and the resulting share-based compensation expenses could have been different.

We believe that the determinations of the fair market value of our common shares were fair and reasonable at the times they were made. Our board of directors' methodologies, approaches and assumptions consistent with the American Institute of Certified Public Accountants Practice Aid, Valuation of Private-Held-Company Equity Securities Issued as Compensation, or the AICPA Practice Aid.

See " Fair value of our common shares" for more details.

***Acquisition***

We apply the purchase method of accounting to account for our acquisitions. We determine the acquisition date based on the date at which all required licenses are transferred to us and we obtained control of the acquiree.

Purchase consideration generally consists of cash, contingent consideration and equity securities. In estimating the fair value of equity compensation, we consider both income and market approach and selected the methodology that is most indicative of our fair value in an orderly transaction between market participants as of the measurement date. Under the market approach, we utilize publicly-traded comparable company information to determine the revenue and earnings multiples that are used to value our equity securities. Under the income approach, we determine the fair value of our equity securities based on the estimated future cash flow discounted by an estimated weighted-average cost of capital, which reflects the overall level of inherent risk and the rate of return an outside investor would expect to earn. We base the cash flow projections on forecasted cash flows derived from the most recent annual financial forecast using a terminal value based on the perpetuity growth model.

The identifiable assets acquired and liabilities and contingent liabilities assumed in a business acquisition are measured initially at the fair value at the acquisition date. The excess of the cost of acquisition over the fair value of the identifiable net assets acquired is recorded as goodwill.

We are responsible for determining the fair value of the equity issued, assets acquired, liabilities assumed and intangibles identified as of the relevant acquisition date. Post-acquisition expenses are charged to general and administrative expenses directly.

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***Goodwill***

Goodwill represents the amount by which the cost of acquired net assets in a business acquisition exceeds the fair value of the net identifiable assets on the date of purchase. Goodwill is carried at cost less accumulated impairment losses. Goodwill is allocated to the reporting units that are expected to benefit from the business combination in which the goodwill arises for the purpose of impairment testing. If the carrying value of the reporting unit exceeds its fair value, an impairment loss is recorded to the extent that the carrying value of goodwill exceeds its fair value. We have determined that the reporting units for testing goodwill impairment are the operating segments that constitute a business for which discrete financial information is available and for which management regularly reviews the operating results. We currently have one reporting unit.

Estimating fair value is performed by utilizing various valuation techniques, with the primary technique being the discounted cash flow method. There are inherent limitations in any estimation technique and a minor change in the assumption could result in a significant change in its estimate of fair value, thereby increasing or decreasing the amounts of our consolidated assets, shareholders' equity and net income or loss.

We perform an impairment test on October 1 of each year or whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable.

***Intangible assets***

Intangible assets that are acquired in business acquisitions are recognized apart from goodwill if the intangible assets arise from contractual or other legal rights, or are separately identifiable if the intangible assets do not arise from contractual or other legal rights.

The costs of determinable-lived intangible assets are amortized to expense over their estimated life and stated at cost (fair value at acquisition) less accumulated amortization. The value of indefinite-lived intangible assets is not amortized, but tested for impairment annually on October 1 of each year, or whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. We reassess indefinite-lived intangible assets at each reporting period to determine whether events or circumstances continue to support an indefinite useful life.

***Impairment of investment, long-lived assets and intangible assets***

The carrying amounts of investment, long-lived assets and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is evaluated by a comparison of the carrying amount of assets to future undiscounted net cash flows expected to be generated by the assets. Such assets are considered to be impaired if the sum of the expected undiscounted cash flow is less than carrying amount of the assets. The impairment to be recognized is measured by the amount by which the carrying amounts of the assets exceed the fair value of the assets. RMB1.9 million of impairment of investments was recognized for the years ended December 31, 2011, RMB0.6 million of impairment of intangible assets was recognized for the year ended December 31, 2012, and RMB0.9 million (US\$0.15 million) of impairment of investments was recognized for the year ended December 31, 2013.

***Taxation and uncertain tax positions***

Current income tax is provided on the basis of income for financial reporting purposes, adjusted for income and expense items which are not assessable or deductible for income tax purposes. In accordance with the regulations of the relevant tax jurisdictions, deferred income taxes are accounted for using the liability approach which requires the recognition of income taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in our financial statements or tax returns. Deferred income taxes are determined based on the differences between the financial reporting and tax basis of assets and liabilities and are

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measured using the currently enacted tax rates and laws. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the consolidated statements of operations in the period that includes the enactment date.

We currently have deferred tax assets resulting from net operating loss carryforwards and deductible temporary differences, all of which are available to reduce future tax payable in our significant tax jurisdictions. The largest component of our deferred assets are the temporary differences generated by our PRC subsidiary and VIE due to recognition of the deferred revenue. In assessing whether such deferred tax assets can be realized in the future, we need to make judgments and estimates on the ability of each of our PRC subsidiary and VIE to generate taxable income in the future years. To the extent that we believe it is more likely than not that some portion or the entire amount of deferred tax assets will not be realized, we established a total valuation allowance to offset the deferred tax assets. As of December 31, 2011, 2012 and 2013, a total valuation allowance of RMB1.9 million, RMB4.2 million and RMB22.2 million (US\$3.7 million), respectively, was recognized against deferred tax assets. If we subsequently determine that all or a portion of the temporary differences are more like than not to be realized, the valuation allowance will be released, which will result in a tax benefit in our consolidated statements of operations.

We adopted the guidance on accounting for uncertainty in income taxes on January 1, 2008. The guidance prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Guidance was also provided on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. Significant judgment is required in evaluating our uncertain tax positions and determining the relevant provision for income taxes. The adjustment to the opening balance of retained earnings as of January 1, 2008 as a result of the implementation of the guidance was zero. The interest and penalties associated with tax positions for the years ended December 31, 2011 2012 and 2013 was zero. As of December 31, 2011, 2012 and 2013, we had no significant unrecognized uncertain tax positions.

***Foreign currency***

We use Renminbi as our reporting currency. The functional currency of our company, incorporated in the Cayman Islands, and our subsidiaries incorporated in the British Virgin Islands and Hong Kong is U.S. dollars, while the functional currency of the other entities is Renminbi. In the consolidated financial statements, the financial information of our company and our subsidiaries which use U.S. dollars as their functional currency have been translated into Renminbi. Assets and liabilities are translated at the exchange rates on the balance sheet date, equity amounts are translated at historical exchange rates, and revenues, expenses, gains and losses are translated using the average rate for the year. Translation adjustments arising from these are reported as other comprehensive income or loss in the statements of operations and comprehensive loss.

Foreign currency transactions denominated in currencies other than functional currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are re-measured at the applicable rates of exchange in effect at that date. Foreign exchange gains and losses resulting from the settlement of such transactions and from re-measurement at year-end are recognized in foreign currency exchange gains (losses), net in the consolidated statements of operations and comprehensive income (loss).

***Fair value of our common shares***

Prior to the completion of the initial public offering, in determining the fair values of our common shares as of each award grant date, three generally accepted approaches to value were considered: cost, market and income approaches. While useful for certain purposes, the cost approach is generally not

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considered applicable to the valuation of a company as a going concern, as it does not capture the future earning potential of the business. The comparability of the financial metrics of comparable companies in our industry and thus the relevance of the market approach based on guideline companies method were also considered low because our target market and stage of development were different from those of the publicly listed companies in the same industry. In view of the above, we determined that the income approach is the most appropriate method to derive the fair values of our common shares for valuation dates with no equity transaction close to the award grant date. In case we have own equity transactions close to the award grant date, guideline transaction method of the market approach or backsolve method were adopted. In addition, we took into consideration the guidance prescribed by the AICPA Practice Aid.

Prior to the completion of the initial public offering, we are a private company with no quoted market prices for our common shares. We have therefore estimated, with assistance from an independent valuation firm, the fair value of our common shares at certain dates in 2010, 2011 and 2012 for the following purposes:

- (a) to determine the fair value of our common shares at the date of the grant and re-purchase date of a share-based compensation award as one of the inputs into determining the fair value of the award as of the grant date or the re-purchase date;
- (b) to determine the fair value of warrants issued to Tiger Global Six YY Holdings as of the issuance date and re-measurement date; and
- (c) to determine the fair value of our common shares at the date of the grant of restricted shares and restricted share units as one of the inputs into determining the fair value of the award as of the grant date.

The following table sets forth the fair values of our common shares estimated from July 1, 2010 to September 30, 2012:

Date	Fair Value of Common Shares (US\$ per share) (US\$)	Type/Methodology of Valuation	Purpose of Valuation
July 1, 2010	0.4666	Retrospective/ GTM(1)	(a)
October 1, 2010	0.6988	Retrospective/ GTM(1)	(a)
January 1, 2011	0.9362	Retrospective/ Backsolve(2)	(b)
May 1, 2011	0.9952	Retrospective/ GTM(1)	(a)
September 16, 2011	1.0630	Contemporaneous/ DCF(3)	(c)
January 1, 2012	1.0869	Contemporaneous/ DCF(3)	(c)
March 31, 2012	1.1153	Contemporaneous/ DCF(3)	(c)
June 30, 2012	1.1335	Contemporaneous/ DCF(3)	(c)
July 15, 2012	1.1284	Contemporaneous/ DCF(3)	(c)
September 1, 2012	1.1146	Contemporaneous/ DCF(3)	(c)
September 30, 2012	1.1437	Contemporaneous/ DCF(3)	(c)

- (1) GTM denotes guideline transaction method under market approach based on the enterprise value to revenue multiples of our own equity transactions close to the valuation date.
- (2) Backsolve denotes the back solve method under market approach based on our own equity transactions as of the valuation date.
- (3) DCF denotes the discounted cash flow method under the income approach which explicitly recognizes that the business enterprise value as of the valuation date is developed by discounting future net cash flow to the present value at a rate that reflects both the current return requirements of the market and the risks inherent in the specific investment.

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When estimating the fair value of the common shares, our management considered a number of factors, including the result of an independent third party appraisal and the equity transactions conducted by our company, while taking into account standard valuation methods and the achievement of certain events. We adopted a retrospective valuation instead of a contemporaneous valuation for valuation dates prior to August 2011 with the assistance of an independent valuation company because, at that time, our financial and other resources were mainly focused on our research and development efforts.

Due to the changing environment in which we are operating, a number of assumptions were established in deriving the fair value of our common shares. These assumptions include: there will be no major changes in the existing political, legal, fiscal and economic conditions in China; there will be no major changes in the current taxation law in China; exchange rates and interest rates will not differ materially from those presently prevailing; the availability of finance will not be a constraint on the future growth of our operations; we will retain and have competent management, key personnel, and technical staff to support our ongoing operations; and industry trends and market conditions for related industries will not deviate significantly from economic forecasts.

Since our initial public offering, the fair value of our common shares is based on the closing prices of our publicly traded shares.

*Equity value as of September 16, 2011, January 1, 2012, March 31, 2012, June 30, 2012 and September 30, 2012*

Valuation of common equity as of September 16, 2011, January 1, 2012, March 31, 2012, June 30, 2012 and September 30, 2012 are based on the income approach discounted cashflow analysis. The income approach involves applying appropriate discount rates to estimated cash flows that are subject to a number of assumptions. These assumptions include: (i) no material changes in the existing political, legal, fiscal and economic conditions in China; (ii) our ability to recruit and retain competent management, key personnel and technical staff to support our ongoing operations; (iii) exchange rates and interest rates will not differ materially from those presently prevailing; (iv) the availability of financing will not be a constraint on the future growth of our operation; and (v) industry trends and market conditions for related industries will not deviate significantly from economic forecasts. These assumptions are inherently uncertain and subjective.

The risks associated with achieving an estimated cash flow were assessed in selecting the appropriate discount rates. The discount rates were based on the estimated market required rate of return for investing in our company, or weighted average cost of capital, or WACC, which was derived using the capital asset pricing model, a method that market participants commonly use to price securities. The change in WACC was the combined result of the changes in risk-free interest rate, industry-average correlative relative volatility coefficient beta, equity risk premium, size of our company, scale of our business and our ability in achieving forecast projections.

A discount for lack of marketability, or DLOM, was also applied to reflect the fact there was no ready public market for our shares as we were a closely held private company. DLOM was quantified using the Black-Scholes option pricing model. Under this option-pricing method, the cost of the put option, which can hedge the price change before the privately held shares can be sold, was considered as a basis to determine the DLOM. This option pricing method is one of the methods commonly used in estimating DLOM as it can take into consideration factors such as timing of a liquidity event (such as an initial public offering) and estimated volatility of equity securities. The farther the valuation date is from an expected liquidity event, the higher the put option value and thus the higher the implied DLOM. The lower the DLOM used for the valuation, the higher the determined fair value of the common shares.

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The discount rates and DLOM used are provided as follows:

Valuation dates	WACC	DLOM
September 16, 2011	16.5%	15.0%
January 1, 2012	16.0%	15.0%
March 31, 2012	16.0%	15.0%
June 30, 2012	16.0%	15.0%
September 30, 2012	18.0%	10.0%

*Equity value as of January 1, 2011*

We issued common shares and warrants to Tiger, an independent investor, in January 2011. We adopted the Backsolve Method to determine the equity value of our company by matching the sum of fair value of common shares issued and warrants granted to Tiger with the consideration of US\$50.0 million.

*Equity value as of July 1, 2010, October 1, 2010 and May 1, 2011*

During the year 2010, we mainly focused on raising peak concurrent user levels and exploring new revenue sources related to YY such as virtual items sold in music channels created by YY users. Hence, we did not prepare financial projections. Since our operating costs such as staff costs and network expenses are relatively fixed in nature, we judged it reasonable to assume that our increase in business enterprise value was in a linear relationship with the increase in revenue. As such, a linear relationship of around 41 times, devised from the increase of business enterprise value between series C financing as of November 1, 2009 and the warrants issued to Tiger as of January 2011 over the increase of corresponding 12-month trailing revenues, was applied to the 12-month trailing revenue as of the valuation date to estimate the business enterprise value and hence equity value as of each valuation date stated in this section. We adopted the GTM for these valuation dates.

*Allocation of equity value*

Our equity values determined at the respective valuation dates based on the above assumptions were allocated between the preferred shares and common shares using the option pricing model taking into account the guidance prescribed by the AICPA Practice Aid. We have taken into consideration estimates of the anticipated timing of a potential liquidity event, such as an initial public offering, and estimates of the volatility of our equity securities. The anticipated timing is based on the plans of our board and management. The estimated volatility was derived by referring to the average annualized standard deviation of the share prices of listed comparable companies for the historical period matching with the terms of the options. Estimating the volatility of the share price of a privately held company is complex because there is no readily available market for the shares. The volatility of our shares was estimated based on the historical volatility of the shares of comparable listed companies. Had we used different estimates of volatility, the allocations between preferred and common shares would have been different.

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**Results of Operations**

The following table sets forth a summary of our consolidated results of operations for the years indicated. Our business has grown rapidly since our inception. Our limited operating history makes it difficult to predict future operating results. We believe that period-to-period comparisons of results of operations should not be relied upon as indicative of future performance.

	For the Year Ended December 31,							
	2011		2012		2013			
	RMB	% of total net revenues	RMB	% of total net revenues	RMB	US\$	% of total net revenues	
Total net revenues <sup>(1)</sup>	319,655	100.0	820,031	100.0	1,823,468	301,217		100.0
IVAS:								
Online music and entertainment	52,854	16.5	286,446	34.9	852,885	140,887		46.8
Online games	165,933	51.9	332,287	40.5	602,111	99,462		33.0
Others	13,589	4.3	83,655	10.2	205,212	33,899		11.2
Online advertising	87,279	27.3	117,643	14.3	163,260	26,969		9.0
Cost of revenues	(182,699)	(57.2)	(416,133)	(50.7)	(881,999)	(145,696)		(48.4)
Gross profit	136,956	42.8	403,898	49.3	941,469	155,521		51.6
Operating expenses								
Research and development expenses	(106,804)	(33.4)	(176,725)	(21.6)	(267,005)	(44,106)		(14.6)
Sales and marketing expenses	(13,381)	(4.2)	(16,954)	(2.1)	(24,955)	(4,122)		(1.4)
General and administrative expenses	(118,241)	(37.0)	(109,788)	(13.4)	(200,554)	(33,129)		(11.0)
Total operating expenses	(238,426)	(74.6)	(303,467)	(37.0)	(492,514)	(81,357)		(27.0)
Other income	1,982	0.6	2,465	0.3	27,078	4,473		1.5
Operating (loss) income	(99,488)	(31.1)	102,896	12.5	476,033	78,637		26.1
Gain on disposal of an equity investment			651	0.1				
Gain on disposal of a cost investment			2,351	0.3				
Foreign currency exchange gains (losses) , net	14,143	4.4	(4,153)	(0.5)	29,555	4,882		1.6
Interest income	4,890	1.5	16,316	2.0	60,221	9,948		3.3
(Loss) income before income tax expenses	(80,455)	(25.2)	118,061	14.4	565,809	93,467		31.0
Income tax expenses	(1,343)	(0.4)	(29,041)	(3.5)	(89,951)	(14,859)		(4.9)
(Loss) income before share of loss (income) in equity method investments, net of income taxes	(81,798)	(25.6)	89,020	10.9	475,858	78,608		26.1



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Share of (loss) income in equity method investment, net of income taxes	(1,358)	(0.4)	157	0.0	1,869	309	0.1
Net (loss) income attributable to YY Inc.	(83,156)	(26.0)	89,177	10.9	477,727	78,917	26.2

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(1) Net of rebates and discounts.

Table of Contents**Year Ended December 31, 2013 Compared to Year Ended December 31, 2012**

**Net Revenues.** Our net revenues increased by 122.4% from RMB820.0 million in 2012 to RMB1,823.5 million (US\$301.2 million) in 2013. This increase was primarily due to the increased contribution of revenues from online music and entertainment and increases in our online game revenues as well as other sources including our membership program and live game broadcasting, and to a lesser extent, an increase in our online advertising revenues.

**IVAS revenues.** Our IVAS revenues, which consisted of revenues from online music and entertainment, online games as well as other sources, increased by 136.4% from RMB702.4 million in 2012 to RMB1,660.2 million (US\$274.2 million) in 2013. The overall increase primarily reflected an increase in the number of paying users and, to a lesser extent, an increase in ARPU. Our number of paying users increased from approximately 2.4 million in 2012 to 3.2 million in 2013. Our ARPU for IVAS increased from RMB296.5 in 2012 to RMB525.2 (US\$86.8) in 2013. The increase in paying users and ARPU were primarily due to (a) our ability to offer new and attractive products and services that allow us to monetize our platform; (b) our ability to attract and retain a large and engaged user base through hosting an increasing number of events and activities; and (c) our ability to attract third party game developers and service providers as well as certain popular performers and channel owners.

Revenues from online music and entertainment increased by 197.7% from RMB286.4 million for 2012 to RMB852.9 million (US\$140.9 million) for 2013. In addition to the increase in the number of paying users and ARPU, the increase in revenues from online music and entertainment was also due to the increasing popularity of online music and entertainment. Our paying users for online music and entertainment increased from approximately 845,000 for 2012 to 1,748,000 for 2013. The increasing popularity of online music and entertainment is primarily due to the increased number of activities we hosted.

Revenues from online games increased by 81.2% from RMB332.3 million in 2012 to RMB602.1 million (US\$99.5 million) in 2013. This increase was primarily attributable to an increase in the attractiveness of our online game platform and the popularity of the online games we offer. Our paying users for online games increased from approximately 966,000 for 2012 to 1,308,000 for 2013. The number of online games we operated as of December 31, 2012 was 73 as compared to 126 as of December 31, 2013.

Other IVAS revenues, which primarily consisted of revenues from membership subscription fees and live game broadcasting, increased by 145.3% from RMB83.7 million in 2012 to RMB205.2 million (US\$33.9 million) in 2013. This increase was primarily due to an increase in the number of users who subscribed to our membership program and an increase in the popularity of live game broadcasting.

**Online advertising revenues.** Our online advertising revenues increased by 38.8% from RMB117.6 million in 2012 to RMB163.3 million (US\$27.0 million) in 2013. This increase was primarily due to the increasing popularity of Duowan.com and YY Client.

**Cost of Revenues.** Our cost of revenues increased by 112.0% from RMB416.1 million in 2012 to RMB882.0 million (US\$145.7 million) in 2013. The increase in our cost of revenues was due in large part to an increase in our revenue sharing fees and content costs, which consist of the payments to performers, channel owners and content providers, which amounted to RMB444.1 million (US\$73.4 million) in 2013, representing a 306.4% increase from RMB109.3 million in 2012. This increase in revenue sharing fees and content costs was primarily due to higher levels of user engagement and spending. We also incurred a non-recurring cost in 2013 due to our partnership with Hunan Satellite Television Station in the *2013 Happy Boy Show*. Bandwidth costs increased 40.1% from RMB145.0 million in 2012 to RMB203.2 million (US\$33.6 million) in 2013 to support our growing business operations. In addition, salary and welfare costs increased 76.9% from RMB50.0 million in

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2012 to RMB88.5 million (US\$14.6 million) in 2013, mainly due to our hiring of additional employees to serve our rapidly expanding user base.

**Operating Expenses.** Our operating expenses increased by 62.3% from RMB303.5 million in 2012 to RMB492.5 million (US\$81.4 million) in 2013, primarily due to an increase in general and administrative expenses as well as research and development expenses, which was associated with the general growth of our business operations, our commitment to research and development and the advancements in our technology development.

**Research and development expenses.** Our research and development expenses increased by 51.1% from RMB176.7 million in 2012 to RMB267.0 million (US\$44.1 million) in 2013. This increase was primarily due to an increase in salaries and other benefits for research and development personnel, which was in turn mainly driven by an increase in the number of our research and development staff, especially engineers, which accounts for approximately 53.9% of our total number of employees in 2013.

**Sales and marketing expenses.** Our sales and marketing expenses increased by 47.2% from RMB17.0 million in 2012 to RMB25.0 million (US\$4.1 million) in 2013. This increase was primarily due to an increase in salaries and other benefits for sales and marketing personnel and an increase in our spending on promotional activities we hosted.

**General and administrative expenses.** Our general and administrative expenses increased by 82.7% from RMB109.8 million in 2012 to RMB200.6 million (US\$33.1 million) in 2013. This increase was primarily due to an increase in salaries and other benefits for general and administrative personnel, which was in turn mainly driven by an increase in the number of our general and administrative staff. In addition, share-based compensation allocated to general and administrative expenses increased from RMB55.6 million in 2012 to RMB66.3 million (US\$11.0 million) in 2013.

**Foreign Currency Exchange Gains (Losses).** We had net foreign currency exchange gains of RMB29.6 million (US\$4.9 million) in 2013, compared to a net foreign currency exchange losses of RMB4.2 million in 2012. This increase was primarily due to the fact that the proceeds from our initial public offering were converted from U.S. dollars into Renminbi in the fourth quarter of 2012 and appreciation of Renminbi against U.S. dollars.

**Interest Income.** Our interest income increased from RMB16.3 million in 2012 to RMB60.2 million (US\$9.9 million) in 2013. This increase was primarily due to higher levels of cash on hand and short-term deposits, partly as a result of depositing cash generated from our operations, and a portion of the proceeds from our initial public offering in November 2012.

**Income Tax Expenses.** We recorded income tax expenses of RMB29.0 million in 2012 compared to RMB90.0 million (US\$14.9 million) in 2013. This increase was primarily due to the higher income before income tax expenses recorded by certain of our PRC subsidiaries and consolidated affiliated entities.

**Net Income.** As a result of the foregoing, we had a net income of RMB477.7 million (US\$78.9 million) in 2013 as compared to a net income of RMB89.2 million in 2012.

### **Year Ended December 31, 2012 Compared to Year Ended December 31, 2011**

**Net Revenues.** Our net revenues increased by 156.5% from RMB319.7 million in 2011 to RMB820.0 million in 2012. This increase was primarily due to increases in our online game revenues and the increased contribution of revenues from online music and entertainment, which was officially launched in March 2011 as well as other sources including our membership program, which was launched in October 2011, and to a lesser extent, an increase in our online advertising revenues.

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*IVAS revenues.* Our IVAS revenues, which consisted of revenues from online music and entertainment and online games as well as other sources, increased by 202.3% from RMB232.4 million in 2011 to RMB702.4 million in 2012. The overall increase primarily reflected an increase in the number of paying users and, to a lesser extent, an increase in ARPU. Our number of paying users increased from approximately 1.4 million in the year ended December 31, 2011 to 2.4 million for the year ended December 31, 2012. This increase in paying users was attributable to (i) a significant increase in the number of average monthly active users from 51.9 million in the three months ended December 31, 2011 to 69.7 million in the three months ended December 31, 2012, (ii) an increase in the number of web games we operated and therefore the volume of new virtual items a user may purchase and (iii) the official launch and increasing popularity of online music and entertainment and the introduction of our membership program. Our ARPU for IVAS increased from RMB164.3 in 2011 to RMB296.5 for 2012.

Revenues from online music and entertainment increased from RMB52.9 million for 2011 to RMB286.4 million for 2012. In addition to the increase in paying users and ARPU, the increase in revenues from online music and entertainment was also due to the increasing popularity of online music and entertainment since its official launch in March 2011. The increasing popularity of online music and entertainment is attributable to several factors: (a) in June 2011, we began paying certain popular performers and channel owners on online music and entertainment, which attracted more talented performers and channel owners to our platform and resulted in greater performer and channel owner participation on YY channels, which in turn led to higher attendance in YY channels, more loyal audiences and more paying users; (b) we have expanded the range of virtual item offerings on our online music and entertainment since its inception, and these virtual items now include flowers, glow sticks, beer and chocolate, and (c) we launched video functionalities in online music and entertainment channels in the first quarter of 2012, which helped further enhance the attractiveness of online music and entertainment to users. We believe that the combination of higher audience participation, a growing range of appealing virtual items offered and enhanced functionalities on online music and entertainment have all contributed to the increased revenues generated from the sale of virtual items on our online music and entertainment channels. Our paying users for online music and entertainment increased from approximately 405,000 for the year ended December 31, 2011 to 845,000 for the same period in 2012.

Revenues from online games, all from web games, increased by 100.3% from RMB165.9 million in 2011 to RMB332.3 million in 2012. The number of online games we hosted increased from 45 as of December 31, 2011 to 73 as of December 31, 2012. Our paying users for online games increased from approximately 871,000 for the year ended December 31, 2011 to 966,000 for the year ended December 31, 2012.

Other IVAS revenues, which primarily consisted of revenues from membership subscription fees and in-channel activities increased from RMB13.6 million in 2011 to RMB83.7 million in 2012. This increase was primarily attributable to an increase in the number of users who subscribed to our membership program and paid the monthly subscription fee; we had approximately 508,000 such members as of December 31, 2012.

*Online advertising revenues.* Our online advertising revenues increased by 34.7% from RMB87.3 million in 2011 to RMB117.6 million in 2012. This increase was primarily attributable to an increase in the average revenue per advertiser which increased from approximately RMB623,000 in 2011 to RMB871,000 in 2012. This increase was partly driven by (a) the increase in the number of our average daily unique visitors to Duowan.com from 9.9 million in December 2011 to 19.1 million in December 2012, making online advertising on Duowan.com more attractive to a larger number of online game developers as an effective way to market games to a larger audience, (b) an increase in the average prices for our advertising slots due to Duowan.com's increasing popularity, and (c) the effective efforts of our sales and marketing team in promoting advertising on Duowan.com.

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**Cost of Revenues.** Our cost of revenues increased by 127.8% from RMB182.7 million in 2011 to RMB416.1 million in 2012. The increase in our cost of revenues was due in large part to increases in bandwidth costs, which increased by 93.1% from RMB75.1 million in 2011 to RMB145.0 million in 2012 and an increase in our revenue sharing fees and content costs. The increase in bandwidth costs was primarily due to (i) an increase in the amount of bandwidth required since we provided video functionality to an increasing number of our channels in 2012 and (ii) an increase in the number of average monthly active users on our platform from approximately 51.9 million in the three months ended December 31, 2011 to 69.7 million in the three months ended December 31, 2012. Our revenue sharing fees and content costs, consisting of the payments to channel owners and performers in our online music and entertainment channels and those entitled to revenue sharing in various channels activities in YY platform, such as the channel owners in live game broadcasting, and content owners of products sold in YY platform, amounted to RMB109.3 million in 2012 as our IVAS revenues from the sale of virtual items on our online music and entertainment channels increased. In addition, salary and welfare costs increased from RMB33.4 million in 2011 to RMB50.0 million in 2012, mainly due to our hiring of additional employees to serve our rapidly expanding user base. Payment handling costs increased from RMB9.3 million in 2011 to RMB22.8 million in 2012, primarily because of the higher IVAS sales and an increase in the number of users paying through third party payment channels.

**Operating Expenses.** Our operating expenses increased by 27.3% from RMB238.4 million in 2011 to RMB303.5 million in 2012, primarily due to an increase in research and development expenses, which reflected the general growth of our business operations, partially offset by a decrease in share-based compensation expenses.

**Research and development expenses.** Our research and development expenses increased by 65.4% from RMB106.8 million in 2011 to RMB176.7 million in 2012. This increase was primarily due to a significant increase in salaries and other benefits for research and development personnel, which was in turn mainly driven by an increase in our research and development staff, especially engineers, from 401 as of December 31, 2011 to 672 as of December 31, 2012. In addition, share-based compensation allocated to research and development expenses increased from RMB31.7 million in 2011 to RMB35.4 million in 2012.

**Sales and marketing expenses.** Our sales and marketing expenses increased by 26.9% from RMB13.4 million in 2011 to RMB17.0 million in 2012. This increase was primarily due to the fact that we hosted a live celebration event on YY in July 2012 to celebrate the fourth anniversary of the launch of YY platform, leading to an increase in our sales and marketing expenses. Share-based compensation allocated to sales and marketing expenses decreased from RMB1.3 million in 2011 to RMB0.9 million in 2012.

**General and administrative expenses.** Our general and administrative expenses decreased by 7.1% from RMB118.2 million in 2011 to RMB109.8 million in 2012. This decrease was primarily due to a lower amount of share-based compensation expenses being allocated to general and administrative expenses from RMB86.5 million in 2011 to RMB55.6 million in 2012.

**Foreign Currency Exchange (Loss) Gains.** We had net foreign currency exchange loss of RMB4.2 million in 2012, compared to a net foreign currency exchange gain of RMB14.1 million in 2011. This decrease was primarily due to the fact that we converted our proceeds from our initial public offering from U.S. dollars into Renminbi and recognized an exchange loss.

**Interest Income.** Our interest income increased from RMB4.9 million in 2011 to RMB16.3 million in 2012. This increase was primarily due to higher levels of cash on hand, partly as a result of depositing the proceeds from our initial public offering in November 2012 and issuance of common shares to Tiger Global Six YY Holdings into various bank accounts.

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**Income Tax Expenses.** We recorded income tax expenses of RMB1.3 million in 2011 compared to RMB29.0 million in 2012. This increase was primarily due to the higher revenues recorded by certain of our PRC subsidiaries.

**Net Income (Loss).** As a result of the foregoing, we had a net income of RMB89.2 million in 2012 as compared to a net loss of RMB83.2 million in 2011.

**Inflation**

Since our inception, inflation in China has not materially impacted our results of operations. According to the National Bureau of Statistics of China, the change of consumer price index in China was 5.4%, 2.6% and 2.6% in 2011, 2012 and 2013, respectively. Although we have not in the past been materially affected by inflation since our inception, we can provide no assurance that we will not be affected in the future by higher rates of inflation in China.

**Recently Issued Accounting Pronouncements**

In February of 2013, the FASB issued ASU 2013-02, "*Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*". The amendments in this ASU require an entity to provide information about amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income (for example, where amounts are reclassified to inventory), an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. For public entities, the amendments are effective with prospective application for reporting periods beginning after December 15, 2012. We adopted this ASU beginning January 1, 2013 and the adoption of this ASU did not have a material impact on our consolidated financial statements.

In March of 2013, the FASB issued ASU 2013-05, "*Foreign Currency Matters (Topic 830), Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity*." The amendments in this ASU clarify the applicable guidance for the de-recognition of all or a portion of a cumulative translation adjustment when an entity ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity or when other changes stipulated in the ASU occur and involve a foreign entity. The amendments are effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. The amendments should be applied prospectively to derecognition events occurring after the effective date. Prior periods should not be adjusted. Early adoption is permitted. If an entity elects to early adopt the amendments, it should apply them as of the beginning of the entity's fiscal year of adoption. The adoption of this ASU is not reasonably expected in the future to have a material impact on our consolidated financial statements.

In March of 2013, the FASB issued ASU 2013-11, "*Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*". The amendments in the ASU clarify that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss, similar tax loss, or tax credit carryforward, except as noted in the following sentence. To the extent a net operating loss, similar tax loss, or tax credit carryforward

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is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such a purpose, then under this exception the unrecognized tax benefit is to be presented in the financial statements as a liability and should not be combined with (netted with) the deferred tax asset(s). The assessment of whether a deferred tax asset is "available" is based on the unrecognized tax benefit and deferred tax asset amounts that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of this ASU is not reasonably expected in the future to have a material impact on the our consolidated financial statements.

**B. Liquidity and Capital Resources*****Cash Flows and Working Capital***

In recent years, we have financed our operations primarily through cash flows from operations and the proceeds from our initial public offering in November 2012. We expect to require cash to fund our ongoing operational needs, particularly our revenue sharing fees and content costs, salaries and benefits, bandwidth costs and potential acquisitions or strategic investments. We believe that our current cash and cash equivalents and the anticipated cash flow from operations will be sufficient to meet our anticipated working capital requirements and capital expenditures needs for the next 12 months. However, we may require additional cash resources due to changing business conditions or other future developments, including any investments or acquisitions we may decide to selectively pursue. If our existing cash resources are insufficient to meet our requirements, we may seek to sell equity or equity-linked securities, debt securities or borrow from banks.

As of December 31, 2011, 2012 and 2013, we had RMB128.9 million, RMB504.7 million and RMB729.6 million (US\$120.5 million), respectively, in cash and cash equivalents.

The following table sets forth a summary of our cash flows for the years indicated:

	For the Year Ended December 31,			
	2011	2012	2013	
	RMB	RMB	RMB	US\$
	(in thousands)			
Net cash provided by operating activities	99,817	356,852	891,173	147,211
Net cash used in investing activities	(528,357)	(498,504)	(659,603)	(108,959)
Net cash provided by (used in) financing activities	477,882	522,740	(5,687)	(939)
Net increase in cash and cash equivalents	49,342	381,088	225,883	37,313
Cash and cash equivalents at the beginning of the year period	83,683	128,891	504,702	83,371
Effect of exchange rates change on cash and cash equivalents	(4,134)	(5,277)	(987)	(163)
Cash and cash equivalents at the end of the year period	128,891	504,702	729,598	120,521

***Operating Activities***

Net cash used in or generated from operating activities consists primarily of our net loss or income mitigated by non-cash adjustments, such as share-based compensation, depreciation of property and equipment and deferred taxes, and adjusted by changes in operating assets and liabilities, such as accounts receivable and accrued liabilities, account payables and other payables.

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Net cash provided by operating activities amounted to RMB891.2 million (US\$147.2 million) for the year ended December 31, 2013, primarily resulting from RMB2,225.4 million (US\$367.6 million) of cash revenues we received from the sale of IVAS and advertisements, partially offset by our sales-related cash outflow of RMB665.1 million (US\$109.9 million), which mainly consisted of the amounts due to third party game developers under revenue sharing arrangements, distributions under arrangements with certain performers and channel owners, payment collection costs and business taxes, our employee salaries and welfare payments of RMB317.6 million (US\$52.5million), our payments for the lease of bandwidth of RMB197.5 million (US\$32.6 million) and our general operating costs of RMB154.0 million (US\$25.4 million).

Net cash provided by operating activities amounted to RMB356.9 million for the year ended December 31, 2012, primarily resulting from RMB996.4 million of cash revenues we received from the sale of IVAS and advertisements, partially offset by our employee salaries and welfare payment of RMB244.3 million, our sales-related cash outflow of RMB169.7 million, which mainly consisted of the amounts due to third party game developers under revenue sharing arrangements, distributions under arrangements with certain popular performers and channel owners on our online music and entertainment, payment collection costs and business taxes, our payments for the lease of bandwidth of RMB135.4 million and our general operating costs of RMB90.1 million.

Net cash provided by operating activities for the year ended December 31, 2011 was RMB99.8 million, primarily resulting from RMB395.8 million of cash revenues we received from the sale of IVAS and advertisements, partially offset by our sales-related cash outflow of RMB81.9 million, which mainly consisted of the amounts due to third party game developers under revenue sharing arrangements, payment collection costs and business taxes, our employee salaries and welfare payment of RMB118.0 million, our payments for the lease of bandwidth of RMB71.4 million and our general operating costs of RMB24.7 million.

***Investing Activities***

Net cash used in investing activities largely reflects placements of short-term deposits, purchases of property and equipment in connection with the expansion and upgrade of our technology infrastructure, our investments in certain companies and purchases of intangibles assets.

Net cash used in investing activities amounted to RMB659.6 million (US\$109.0 million) in the year ended December 31, 2013. Net cash used in investing activities primarily resulted from the placement of short-term deposits of RMB1,529.1 million (US\$252.6 million), payments of RMB55.6 million (US\$9.2 million) for the purchase of property and equipment, which mainly consisted of the purchase of servers, and cash paid for certain strategic investments of RMB58.1 million (US\$9.6 million), partially offset by the maturity of short-term deposits in various banks in the amount of RMB996.0 million (US\$164.5 million).

Net cash used in investing activities amounted to RMB498.5 million in the year ended December 31, 2012. Net cash used in investing activities primarily resulted from the placement of short-term deposits of RMB1,040.3 million, consideration of RMB11.7 million paid in connection with an acquisition, and payments of RMB60.9 million for the purchase of property and equipment, which mainly consisted of the purchase of servers to serve our expanded user base and, to a lesser extent, the purchase of office furniture and other office set-up related costs, partially offset by the maturity of term deposits in various banks in the amount of RMB615.3 million.

Net cash used in investing activities amounted to RMB528.4 million in the year ended December 31, 2011. Net cash used in investing activities primarily resulted from the placement of short-term deposits of RMB872.4 million, payments of RMB47.0 million for the purchase of property and equipment, which mainly consisted of the purchase of servers to serve our expanded user base and, to a lesser extent, the purchase of office furniture and other office set-up related costs, and equity



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investments of RMB4.5 million associated with the purchase of a minority equity interest in Zhuhai JinShan KuaiKuai Technology Co., Ltd., a company which provides online game technological research services in China, and Shenzhen Yingpeng Information Technology Company Limited, a company which provides mobile internet related content in China, partly offset by the maturity of term deposits in various banks in the amount of RMB399.7 million.

***Financing Activities***

Net cash used in financing activities was RMB5.7 million (US\$0.9 million) in 2013, primarily attributable to a portion of the listing expenses of RMB5.8 million (US\$0.9 million).

Net cash provided by financing activities was RMB522.7 million in 2012, primarily attributable to the proceeds of RMB550.6 million from our initial public offering in November 2012, partially offset by a portion of the listing expenses of RMB 27.8 million.

Net cash provided by financing activities was RMB477.9 million in the year ended December 31, 2011, primarily attributable to proceeds from the issuance of common shares to Tiger Global Six YY Holdings, net of issuance costs, of RMB489.0 million, partially offset by our repurchase of share options in the amount of RMB11.1 million.

***Capital Expenditures***

We made capital expenditures of RMB41.6 million, RMB79.4 million and RMB72.2 million (US\$11.9 million) in 2011, 2012 and 2013, respectively. Our capital expenditures are primarily used to purchase computers, servers, office furniture, software, domain names and other assets. As we expand, we may move to larger offices and purchase additional office furniture and other equipment.

**C. Research and Development, Patents and Licenses, Etc.**

In order to support the kind of multi-user, real-time online voice and video communications on a scale necessary for our platform, we build and develop our own network infrastructure. See "Item 4. Information on the Company B. Business Overview Research and Development" for a description of the research and development aspect of our business and "Item 4. Information on the Company B. Business Overview Intellectual Property" for a description of the protection of our intellectual property.

Research and development expenses consist primarily of salaries and benefits for research and development personnel and rental and depreciation of office premise and servers utilized by the research and development personnel. Research and development expenses generally increased in the past three years ended December 31, 2013, due to the need for additional research and development personnel to accommodate the rapid growth of our business. We expect our research and development expenses in absolute amount to increase as we intend to retain existing research and development personnel and also hire new ones to, among other things, develop new series of applications for our platform, improve technology infrastructure to further enhance user experience, and further develop enhanced features for Mobile YY to reach more users. We incurred RMB106.8 million, RMB176.7 million and RMB267.0 million (US\$44.1 million) of research and development expenses in 2011, 2012 and 2013, respectively.

Table of Contents**D. Trend Information**

Other than as disclosed elsewhere in this annual report, we are not aware of any trends, uncertainties, demands, commitments or events since the beginning of our fiscal year 2013 that are reasonably likely to have a material effect on our net revenues, income from operations, profitability, liquidity or capital resources, or that would cause the disclosed financial information to be not necessarily indicative of future operating results or financial condition.

**E. Off-Balance Sheet Arrangements**

We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of any third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholders' (deficit)/equity, or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

**F. Tabular Disclosure of Contractual Obligations**

The following table sets forth our contractual obligations as of December 31, 2013:

	Total	Payment Due by Period			More than 5 years
		Less than 1 year	1-2 years	3-5 years	
		(in thousands of RMB)			
Operating lease obligations <sup>(1)</sup>	32,728	16,919	15,809		

(1)

Operating lease obligations refer to the lease of offices under operating lease agreements, where a significant portion of the risks and rewards of ownership are retained by the lessor. Payments made under operating leases are charged to the consolidated statements of operations on a straight-line basis over the period of the lease, including any free lease periods.

Our operating lease obligations decreased from December 31, 2012 to December 31, 2013 primarily because we entered into our major leases in 2011 and 2012. Most of these leases are scheduled to expire after 2014, and we have not yet renewed them beyond that date.

Other than the obligations set forth above, we did not have any other long-term debt obligations, operating lease obligations, purchase obligations or other long-term liabilities as of December 31, 2013.

**G. Safe Harbor**

See "Forward Looking Statements" on page 2 of this annual report.

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The following table sets forth information regarding our directors and executive officers as of the date of this annual report. There are no family relationships among any of the directors or executive officers of our company.

Directors and Executive Officers	Age	Position/Title
Jun Lei	44	Chairman of the Board and Director
David Xueling Li	39	Chief Executive Officer and Director
Qin Liu	41	Director
Jenny Hong Wei Lee	41	Independent Director
Tony Bin Zhao	43	Director and Chairman of Technology Committee
Peter Andrew Schloss	53	Independent Director
Peng T. Ong	50	Independent Director
Richard Weidong Ji	46	Independent Director
David Tang	59	Independent Director
Rongjie Dong	37	General Manager of Games Department
Jin Cao	41	General Manager of Website Department
Eric He	53	Chief Financial Officer

*Mr. Jun Lei* is our co-founder and has been our chairman since our inception. Mr. Lei is a co-founder and the chairman of Kingsoft Corporation Limited, a China-based software and online games company listed on the Stock Exchange of Hong Kong, and served as its chief executive officer from October 1998 to December 2007. In 2010, Mr. Lei co-founded and has since then served as the chairman of Xiaomi Corporation, a smartphone and mobile internet company in China. From April 2000 to March 2005, Mr. Lei co-founded and served as chairman of Joyo.com which, during his tenure, was sold to Amazon, becoming Amazon China. Since November 2003, Mr. Lei has served on the board of directors of Wuhan University. In addition, Mr. Lei is active in private investments and currently serves as a director or advisor in several privately held companies that he founded or invested in. Mr. Lei received his bachelor's degree in computer science from Wuhan University in 1991.

*Mr. David Xueling Li* is our co-founder and has been our chief executive officer since our inception. Mr. Li is primarily responsible for our overall management, major decision-making and strategic planning, including research and development. Before founding our company, Mr. Li worked at Netease.com, Inc. from July 2003 to April 2005 and served as its chief editor. In 2000, Mr. Li founded CFP.cn, a website that provided a copyright trading platform for journalists and amateur photographers. Mr. Li received a bachelor's degree in philosophy from Renmin University of China in 1997.

*Mr. Qin Liu* has been a director of our company since June 2008. Mr. Liu has been a director of Morningside China TMT Fund I, L.P. since its formation in 2008, where he is primarily responsible for managing early-stage investments in the internet, wireless, media, entertainment and consumer services sectors in China. He also serves as a director in several non-public portfolio companies of the fund. From 2000 through 2008, Mr. Liu worked at Morningside IT Management Services (Shanghai) Co., Ltd. and established its print media business and served as publisher of The Bund, an upscale lifestyle weekly publication. Mr. Liu received a master's degree in business administration, or MBA, from China Europe International Business School in 1999 and a bachelor's degree in electrical engineering from Beijing Science & Technology University in 1993.

*Ms. Jenny Hong Wei Lee* has served as our director since December 2009. Ms. Lee is a director of Pactera Technology International Ltd., a leading China-based provider of outsourced information

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technology and research and development services, and 21Vianet Group, Inc., a leading China-based carrier-neutral Internet data center services provider; both companies are listed on the Nasdaq Global Market. Ms. Lee is a managing director of Granite Global Ventures III L.L.C., which is a general partner of Granite Global Ventures III L.P. and GGV III Entrepreneurs Fund L.P. From 2002 to 2005, Ms. Lee served as a vice president of JAFCO Asia. Ms. Lee received her bachelor's degree in electrical engineering in 1994 and master's degree in engineering in 1995 from Cornell University. Ms. Lee also has an MBA degree from Kellogg School of Management at Northwestern University in 2001.

*Mr. Tony Bin Zhao* has served as our director since December 2009. He was our chief technology officer from 2008 to 2013, and started serving as our chairman of technology committee since 2013. He founded Agora, Inc in 2013 and serves as its director. Prior to joining us, he founded NeoTasks, LLC in November 2004 and served as its chairman and chief technology officer until 2008. From July to October 2004, he was a senior consultant at Tencent.com. From July 1997 to July 2004, he served as a senior engineer at WebEx Communications Inc. and was responsible for the establishment of audio/video session and backend servers. From 1995 to 1997, he worked as the manager of software department at Beijing Sunstep Technologies Limited. He also founded Beijing Dacheng Infrastructure Projects Consulting Limited in 1994. Mr. Zhao received a bachelor's degree in radio and electronics from Peking University in 1992.

*Mr. Peter Andrew Schloss* has served as our independent director since November 20, 2012. Mr. Schloss is a partner at Phoenix Media Fund L.P., a private equity fund established by Phoenix Television Group, a company listed on the Stock Exchange of Hong Kong, to invest in media and culture-related companies in China. Mr. Schloss has been serving as an independent director and the audit committee chairman of Giant Interactive Group Inc., an NYSE-listed company, since 2007. From 2008 to 2012, Mr. Schloss served as the chief executive officer of Allied Pacific Sports Network Limited, a leading internet and wireless provider of live and on-demand sports programs in Asia. Prior to joining Allied Pacific Sports Network Limited, Mr. Schloss worked at TOM Online Inc., serving as the chief financial officer from 2003 to 2005, as an executive director from 2004 to 2007 and as the chief legal officer from 2005 to 2007. Mr. Schloss received a bachelor's degree in political science and a juris doctor degree from Tulane University.

*Mr. Peng T. Ong* has served as our independent director since November 20, 2012. Mr. Ong is a director of Banean Holdings and advisor to GSR Ventures. He is an independent director of the National Research Foundation of Singapore. In addition, he is a trustee of the Singapore University of Technology and Design and sits on the strategic advisory board of the Chancellor of the University of Illinois. Mr. Ong was an independent director of Singapore Telecommunications Limited through July 2013 and chairs SingTel's group enterprise advisory committee. He served as chairman of Infocomm Investments Pte Ltd, a venture capital fund in Singapore, from 2006 to 2013. Mr. Ong founded Interwoven Inc. (acquired by Autonomy Corporation plc., now part of Hewlett-Packard) and served as its president and chief executive officer from 1995 to 1997 and its chairman from 1995 to 2002. Mr. Ong also founded Ecentuate Inc. which became the foundation of the IBM Singapore Software Lab after being acquired by IBM. In addition, Mr. Ong co-founded Match.com (now part of IAC/InterActiveCorp) and served in various engineering and management positions at Illustra Information Technologies, Inc. (now Informix Corporation, part of IBM), Sybase Inc. (now SAP America, Inc.) and Gensym Corporation. Mr. Ong Peng received a bachelor's degree in electrical engineering from University of Texas at Austin and a master's degree in computer science from University of Illinois at Urbana-Champaign.

*Mr. Richard Weidong Ji* has served as our independent director since May 2013. Mr. Ji is currently establishing his own fund with the goal of investing in Internet technology leaders and consumer brands that help enhance the lives of Chinese consumers. From 2005 to 2012, Mr. Ji served as managing director and head of Asia-Pacific Internet/media investment research at Morgan Stanley Asia Limited. During his time with Morgan Stanley, Mr. Ji was consistently rated as one of the top internet analysts

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covering the Chinese internet according to the Institutional Investor and Greenwich Associates' annual surveys. Over Mr. Ji's career, he has received many awards from reputable publications and research groups including the Financial Times, South China Morning Post, Asiamoney, Absolute Return & Alpha magazine and iResearch Consulting Group. Mr. Ji holds a doctor of sciences degree in biological science from Harvard University, an MBA from the Wharton School of Business at the University of Pennsylvania and a Bachelor of Science from Fudan University in China. He also serves as an independent director of 58.com.

*Mr. David Tang* has served as our independent director since May 2013. Mr. Tang currently serves as a managing director of Nokia Growth Partners, a global venture capital firm that specializes in investing in mobile technologies and mobile businesses. From 2011 to 2012, Mr. Tang was the vice president of the European Union Chamber of Commerce in China, vice chairman of the China Association of Enterprises with Foreign Investments, and vice chairman of the Beijing International Chamber of Commerce. Mr. Tang has spent nearly a decade with the Nokia group, having served as the vice chairman of Nokia (China) Investment Co., Ltd. and chairman of Nokia Telecommunications Ltd. where he was responsible for government relations, strategic partnerships, corporate development, and sustainability. Prior to serving in those roles, he was the vice chairman and vice president of sales for Nokia in the greater China region from 2005 to 2009. Mr. Tang has also held executive positions in other leading global technology firms such as Apple, AMD, 3Com, DEC, and AST. Mr. Tang received his bachelor's degree in Computer Science and Engineering from California State University at Long Beach and a master's degree in Business from California State University at Fullerton.

*Mr. Rongjie Dong* has been the president of the technology department of Guangzhou Huaduo since October 2006 and is currently the general manager of our games department. Prior to joining us, he served as product manager and head of the technology department of 163.com from 2000 to 2006. Mr. Dong received his bachelor's degree in computer hardware from Beijing Information Engineering Institute (now known as Beijing Information Science and Technology University) in 1999.

*Mr. Jin Cao* has been the vice president of Guangzhou Duowan since 2008 and is currently the general manager of our website department. From June 2005 to October 2008, he served as the president of NeoTasks Inc. From January 2000 to February 2006, he served as the chief representative of FATWIRE Corp. From August 1995 to August 1997, he was a senior programmer for the China Aviation and Space Authority (CASA). He founded niba.com, an online video streaming company, in 2006. Mr. Cao received a bachelor's degree in industrial engineering from Tianjin University in 1995 and a master's degree in industrial engineering from University of Cincinnati in 1999.

*Mr. Eric He* has been our chief financial officer since August 2011. He currently also serves as an independent director of Yangxun Computer Technology (Shanghai) Co. Ltd. and Acorn International, Inc., an NYSE-listed company. Prior to joining us, Mr. He served as the chief financial officer of Giant Interactive Group, Inc., an NYSE-listed company, from March 2007 to August 2011. He served as the chief strategy officer of Ninetowns Internet Technology Group from 2004 to 2007. From 2002 to 2004, he served as a private equity investment director for AIG Global Investment Corp (Asia) Ltd. Mr. He received a bachelor's degree in accounting from National Taipei University and an MBA degree from the Wharton School of Business at the University of Pennsylvania. Mr. He is a Certified Public Accountant and Chartered Financial Analyst in the United States.

**B. Compensation of Directors and Executive Officers**

For the fiscal year ended December 31, 2013, we paid an aggregate of RMB10.4 million (US\$1.7 million) in cash, including salaries and bonuses, to our directors and executive officers. For details on the share incentive grants to our directors and officers, see " Share Incentive Plans." For the fiscal year ended December 31, 2013, we made contributions for our directors and executive officers for their pension insurance, medical insurance, housing fund, unemployment and other

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statutory benefits as required by PRC laws in an aggregate amount of RMB0.3 million (US\$0.1 million). We did not set aside or accrue any other pension or retirement benefits for our directors and executive officers for the fiscal year ended December 31, 2013.

**Employment Agreements**

We have entered into employment agreements with our senior executive officers. We may terminate a senior executive officer's employment for cause at any time without remuneration for certain acts of the officer, such as being convicted of any criminal conduct, any act of gross or willful misconduct or any serious, willful, grossly negligent or persistent breach of any employment agreement provision, or engaging in any conduct which may make the continued employment of such officer detrimental to our company. We may also terminate a senior executive officer's employment by giving three months' prior written notice. A senior executive officer may terminate his or her employment at any time by giving three months' written notice, provided that such notice may only be given by the officer any time after the third anniversary of his or her employment.

Each senior executive officer has agreed to hold all information, know-how and records in any way connected with the business of our company, including, without limitation, all formulae, designs, specifications, drawings, data, operations and testing procedures, manuals and instructions and all customer and supplier lists, sales information, business plans and forecasts and all technical or other expertise and all computer software of our company, in strict confidence during and after his or her employment. Each officer also agrees that we shall own all the intellectual property developed by such officer during his or her employment.

**Share Incentive Plans**

We have adopted two share incentive plans, namely, the 2009 Scheme and the 2011 Plan. The purpose of these two share incentive plans is to attract and retain personnel by linking the personal interests of the members of the board, officers, employees and consultants to the success of our business and by providing such individuals with an incentive for outstanding performance. As of February 28, 2014, options to purchase 13,222,005 common shares, 32,775,503 restricted shares and 48,863,978 restricted share units were outstanding under the 2009 Scheme and the 2011 Plan.

***2009 Employee Equity Incentive Scheme***

We adopted the 2009 Scheme in December 2009. In September 2011, YY Inc. assumed all the rights and obligations of Duowan Entertainment Corp. under all share-based compensation previously issued by Duowan Entertainment Corp., including under the relevant award agreement and under the 2009 Scheme, if applicable, and undertook to issue its own common shares upon the exercise of any share-based compensation awards previously issued by Duowan Entertainment Corp., subject to compliance with the terms and conditions of the relevant award agreements and the 2009 Scheme, if applicable.

Under the 2009 Scheme, the maximum number of shares in respect of which options or restricted shares may be granted is 120,020,001.

The following paragraphs summarize the terms of the 2009 Scheme.

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**Types of Awards.** The following briefly describe the principal features of the various awards that may be granted under the 2009 Scheme.

**Options.** Options provide for the right to purchase a specified number of our common shares at a specified price and usually will become exercisable at the discretion of our plan administrator in one or more installments after the grant date. The option exercise price may be paid, subject to the discretion of the plan administrator, in cash or check, in our common shares which have been held by the option holder for such period of time as may be required to avoid adverse accounting consequences, in other property with value equal to the exercise price, through a broker-assisted cashless exercise, or by any combination of the foregoing.

**Restricted Shares.** A restricted share award is the grant of our common shares which are subject to certain restrictions and may be subject to risk of forfeiture. Unless otherwise determined by our plan administrator, a restricted share is nontransferable and may be forfeited or repurchased by us upon termination of employment or service during a restricted period. Our plan administrator may also impose other restrictions on the restricted shares, such as limitations on the right to vote or the right to receive dividends.

**Plan Administration.** Our board or a committee of one or more members of our board duly authorized for the purpose of the 2009 Scheme can act as the plan administrator.

**Award Agreement.** Options or restricted shares granted under the 2009 Scheme are evidenced by an award agreement that sets forth the terms, conditions and limitations for each grant.

**Option Exercise Price.** The exercise price in respect of any option shall be fixed by reference to the date upon which the option (or the relevant part thereof) is granted, and shall be, at the election of the plan administrator, (a) the latest valuation price per share certified by a third party valuer prior to the date of grant of the relevant option (or relevant part thereof) or (b) the latest price per share at which we have issued any shares prior to the date of grant of the relevant option (or relevant part thereof).

**Eligibility.** We may grant awards to our employees, officers and directors or consultants to our members.

**Term of the Awards.** The 2009 Scheme shall be valid and effective for a period of ten years from the date of effectiveness. The term of each option or restricted share grant shall be ten years from the date of the grant.

**Vesting Schedule.** In general, the plan administrator determines the vesting schedule, which is set forth in the award agreement.

**Transfer Restrictions.** Awards for options or restricted shares may not be transferred in any manner by the award holders and may be exercised only by such holders, subject to limited exceptions. Restricted shares may not be transferred during the period of restriction.

**Termination.** The plan administrator may at any time terminate the operation of the 2009 Scheme.

Prior to the adoption of the 2009 Scheme, we granted certain share options to our employees pursuant to certain share option agreements which carried substantially the same terms and conditions with those stipulated in the 2009 Scheme.

**2011 Share Incentive Plan**

We adopted the 2011 Plan in September 2011.

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Under the 2011 Plan, the maximum number of common shares reserved for issuance under the plan is 43,000,000, plus an annual increase of 20,000,000 on the first day of each fiscal year, beginning in 2013, or such smaller number of common shares as determined by our board of directors.

The following paragraphs summarize the terms of the 2011 Plan.

**Types of Awards.** The following briefly describe the principal features of the various awards that may be granted under the 2011 Plan.

**Options.** Options provide for the right to purchase a specified number of our common shares at a specified price and usually will become exercisable at the discretion of our plan administrator in one or more installments after the grant date. The option exercise price may be paid, subject to the discretion of the plan administrator, in cash or check, in our common shares which have been held by the option holder for such period of time as may be required to avoid adverse accounting consequences, in other property with value equal to the exercise price, through a broker-assisted cashless exercise, or by any combination of the foregoing.

**Restricted Shares.** A restricted share award is the grant of our common shares which are subject to certain restrictions and may be subject to risk of forfeiture. Unless otherwise determined by our plan administrator, a restricted share is nontransferable and may be forfeited or repurchased by us upon termination of employment or service during a restricted period. Our plan administrator may also impose other restrictions on the restricted shares, such as limitations on the right to vote or the right to receive dividends.

**Restricted Share Units.** A restricted share unit award is the grant of the right to receive a common share at a future date and may be subject to forfeiture. Our plan administrator has the discretion to set performance objectives or other vesting criteria that will determine the number or value of restricted share units to be granted. Unless otherwise determined by our plan administrator, a restricted share unit is nontransferable and may be forfeited or repurchased by us upon termination of employment or service during a restricted period. Our plan administrator, at the time of grant, specifies the dates on which the restricted share units become fully vested.

**Plan Administration.** Our board or a committee of one or more members of our board duly authorized for the purpose of the 2011 Plan can act as the plan administrator.

**Award Agreement.** Options, restricted shares or restricted shares units granted under the 2011 Plan are evidenced by an award agreement that sets forth the terms, conditions and limitations for each grant.

**Option Exercise Price.** The exercise price in respect of any option shall be determined by the plan administrator and set forth in the award agreement which may be a fixed or variable price related to the fair market value of the shares. The exercise price per share subject to an option may be amended or adjusted in the absolute discretion of the plan administrator, the determination of which shall be final, binding and conclusive.

**Eligibility.** We may grant awards to our employees, consultants or directors.

**Term of the Awards.** The 2011 Plan shall be valid and effective for a period of ten years from the date of effectiveness. The term of each option grant shall not exceed ten years from the date of the grant.

**Vesting Schedule.** In general, the plan administrator determines the vesting schedule, which is set forth in the award agreement.



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**Transfer Restrictions.** Awards for options, restricted shares or restricted share units may not be transferred in any manner by the award holders and may be exercised only by such holders, subject to limited exceptions. Restricted shares may not be transferred during the period of restriction.

**Termination.** The plan administrator may at any time terminate the operation of the 2011 Plan.

The following table summarizes, as of February 28, 2014, the outstanding options granted to our executive officers, directors and other individuals as a group.

	<b>Common Shares Underlying Options Awarded</b>	<b>Exercise Price (US\$/Share)</b>	<b>Date of Grant</b>	<b>Date of Expiration</b>
Rongjie Dong	*	0.004898	January 1, 2008	December 31, 2016
	*	0.005510	January 1, 2008	December 31, 2017
	*	0.006735	January 1, 2009	December 31, 2018
Other Individuals as a Group	10		January 1, 2008	December 31, 2015
	1,063,171	0.005510	January 1, 2008	December 31, 2017
	4,030,254	0.006735	January 1, 2009	December 31, 2018
<b>Total</b>	<b>13,222,005</b>			

\*

The aggregate number of common shares underlying the outstanding options held by this individual is less than 1% of our total outstanding shares.

The following table summarizes, as of February 28, 2014, the outstanding restricted shares granted to our executive officers, directors and other individuals as a group.

<b>Name</b>	<b>Restricted Shares Granted</b>	<b>Date of Grant</b>
Tony Bin Zhao	*	February 1, 2010
	*	January 1, 2011
Jin Cao	*	February 1, 2010
Rongjie Dong	*	January 1, 2010
Other Individuals as a Group	14,376,738	January 1, 2010
	8,745,420	July 1, 2010
	250,000	October 1, 2010
	4,214,010	January 1, 2011
<b>Total</b>	<b>32,775,503</b>	

\*

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The aggregate number of common shares underlying the outstanding restricted shares held by each of these individuals is less than 1% of our total outstanding shares.

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The following table summarizes, as of February 28, 2014, the outstanding restricted share units granted to our executive officers, directors and other individuals as a group.

Name	Common Shares Underlying Restricted Share Units Granted	Date of Grant
David Xueling Li	*	April 30, 2013
Jenny Hong Wei Lee	*	November 7, 2012
Peter Andrew Schloss	*	November 7, 2012
Peng T. Ong	*	November 7, 2012
Richard Weidong Ji	*	May 23, 2013
David Tang	*	May 23, 2013
Tony Bin Zhao	*	March 31, 2012
Eric He	*	September 16, 2011
	*	November 21, 2012
	*	April 30, 2013
Jin Cao	*	April 30, 2013
	*	July 19, 2013
Rongjie Dong	*	April 30, 2013
	*	July 19, 2013
Other Individuals as a Group	3,547,200	September 16, 2011
	1,130,000	January 1, 2012
	3,221,829	March 31, 2012
	400,000	July 15, 2012
	5,674,200	September 1, 2012
	290,000	September 30, 2012
	844,000	March 31, 2013
	13,249	April 18, 2013
	18,499,500	April 30, 2013
	1,292,000	July 19, 2013
	50,000	October 1, 2013
	48,000	November 1, 2013
<b>Total</b>	<b>48,863,978</b>	

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\*  
The aggregate number of common shares underlying the outstanding restricted share units, or RSUs, held by each of these individuals is less than 1% of our total outstanding shares.

### C. Board Practices

Our board of directors currently consists of seven directors. A director is not required to hold any shares in our company to qualify to serve as a director. A director may vote with respect to any contract, proposed contract, or arrangement in which he or she is materially interested. A director may exercise all the powers of the company to borrow money, mortgage its business, property and uncalled capital, and issue debentures or other securities whenever money is borrowed or as security for any obligation of the company or of any third party. See "Item 6. Directors, Senior Management and Employees B. Compensation of Directors and Executive Officers" for a description of the employment agreements we have entered into with our senior executive officers.

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**Committees of the Board of Directors**

We have established an audit committee, a compensation committee and a corporate governance and nominating committee under the board of directors. We have adopted a charter for each of the three committees. Each committee's members and functions are described below.

**Audit Committee.** Our audit committee consists of Mr. Peter Andrew Schloss, Mr. Peng T. Ong and Mr. Richard Weidong Ji, and is chaired by Mr. Schloss. We have determined that each of Mr. Schloss, Mr. Ong and Mr. Ji satisfies the "independence" requirements of Rule 5605(c)(2) of the Listing Rules of the Nasdaq Global Market and meet the independence standards under Rule 10A-3 under the Securities Exchange Act of 1934, as amended. We have determined that Mr. Schloss qualifies as an "audit committee financial expert." The audit committee oversees our accounting and financial reporting processes and the audits of the financial statements of our company. The audit committee is responsible for, among other things:

selecting the independent registered public accounting firm and pre-approving all auditing and non-auditing services permitted to be performed by the independent registered public accounting firm;

reviewing with the independent registered public accounting firm any audit problems or difficulties and management's response;

reviewing and approving all proposed related party transactions, as defined in Item 404 of Regulation S-K under the Securities Act;

discussing the annual audited financial statements with management and the independent registered public accounting firm;

reviewing major issues as to the adequacy of our internal controls and any special audit steps adopted in light of any material control deficiencies;

annually reviewing and reassessing the adequacy of our audit committee charter;

meeting separately and periodically with management and the independent registered public accounting firm; and

reporting regularly to the board.

**Compensation Committee.** Our compensation committee consists of Mr. Jun Lei, Ms. Jenny Hong Wei Lee and Mr. David Tang, and is chaired by Mr. Lei. We have determined that each of Ms. Lee and Mr. Tang satisfies the "independence" requirements of Rule 5605(c)(2) of the Listing Rules of the Nasdaq Global Market. The compensation committee assists the board in reviewing and approving the compensation structure, including all forms of compensation, relating to our directors and executive officers. Our directors may not be present at any committee meeting during which their compensation is deliberated upon. The compensation committee is responsible for, among other things:

reviewing the total compensation package for our executive officers and making recommendations to the board with respect to it;

approving and overseeing the total compensation package for our executives other than the three most senior executives;

reviewing the compensation of our directors and making recommendations to the board with respect to it;

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periodically reviewing and approving any long-term incentive compensation or equity plans, programs or similar arrangements, annual bonuses, and employee pension and welfare benefit plans; and

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selecting compensation consultant, legal counsel or other adviser only after taking into consideration all factors relevant to that person's independence from management.

**Corporate Governance and Nominating Committee.** Our nominating committee consists of Mr. Peng T. Ong, Mr. Qin Liu and Mr. Peter Andrew Schloss, and is chaired by Mr. Ong. We have determined that each of Mr. Ong and Mr. Schloss satisfies the "independence" requirements of Rule 5605(c)(2) of the Listing Rules of the Nasdaq Global Market. The nominating committee assists the board in selecting individuals qualified to become our directors and in determining the composition of the board and its committees. The nominating committee is responsible for, among other things:

recommending nominees to the board for election or re-election to the board, or for appointment to fill any vacancy on the board;

reviewing annually with the board the current composition of the board with regards to characteristics such as independence, age, skills, experience and availability of service to us;

selecting and recommending to the board the names of directors to serve as members of the audit committee and the compensation committee, as well as of the nominating committee itself; and

monitoring compliance with our code of business conduct and ethics, including reviewing the adequacy and effectiveness of our procedures to ensure proper compliance.

**Duties of Directors**

Under Cayman Islands law, our directors have a common law duty of loyalty to act honestly in good faith with a view to our best interests. Our directors also have a duty to exercise the skill they actually possess and such care and diligence that a reasonably prudent person would exercise in comparable circumstances. In fulfilling their duty of care to us, our directors must ensure compliance with our memorandum and articles of association.

**Terms of Directors and Officers**

Our officers are elected by and serve at the discretion of the board. Our directors are not subject to a term of office and hold office until such time as they are removed from office by special resolution of all shareholders. A director will be removed from office automatically if, among other things, the director (1) becomes bankrupt or makes any arrangement or composition with his creditors; or (2) dies or is found by our company to be of unsound mind.

**D. Employees**

The following table sets forth the numbers of our employees, categorized by function, as of December 31, 2013:

Functions	Number of Employees
Management	18
Customer services and operations	482
Engineering and maintenance	123
Research and development	944
Sales and marketing	48
General and administration	136
<b>Total</b>	<b>1,751</b>



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We had a total of 854, 1,298 and 1,751 employees as of December 31, 2011, 2012 and 2013, respectively.

We have developed a corporate culture that encourages initiative, technical superiority and self-development. In addition, we periodically evaluate our employees' performance and provide them with training sessions tailored to each job function to enhance performance and service quality.

As required by regulations in China, we participate in various employee social security plans that are organized by municipal and provincial governments, including pension, unemployment insurance, childbirth insurance, work-related injury insurance, medical insurance and housing insurance. We are required under PRC law to make contributions to employee benefit plans at specified percentages of the salaries, bonuses and certain allowances of our employees, up to a maximum amount specified by the local government from time to time. We believe that we maintain a good working relationship with our employees and we have not experienced any significant labor disputes.

**E. Share Ownership**

**Class A Common Shares**

As of February 28, 2014, we had 672,308,738 Class A common shares outstanding. In addition, as of February 28, 2014, we have granted, and have outstanding, options to purchase a total of 13,222,005 Class A common shares, 32,775,503 restricted shares and 48,863,978 restricted share units to our directors, executive officers, other employees and consultants. For information regarding the Share Incentive Plans, see "Item 6.B. Compensation of Directors and Executive Officers."

**Class B Common Shares**

As of February 28, 2014, we had 436,181,386 Class B common shares outstanding.

**Beneficial Ownership**

The following table sets forth information concerning the beneficial ownership of our common shares as of February 28, 2014, by:

each of our directors and executive officers; and

each person known to us to beneficially own more than 5% of our common shares.

Beneficial ownership is determined in accordance with the rules and regulations of the SEC. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, we have included shares that the person has the right to acquire or that would become unrestricted shares within 60 days after February 28, 2014, the most recent practicable date, including through the exercise of any option, warrant, or other right or the conversion of any other security. These shares, however, are not included in the computation of the percentage ownership of any other person.



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The calculations in the table below assume that there were 672,308,738 Class A common shares outstanding and 436,181,386 Class B common shares as of February 28, 2014.

	Class A Common Shares Beneficially Owned(1)		Class B Common Shares Beneficially Owned(2)		Total Common Shares Beneficially Owned		Total Voting Power(5)
	Number	%	Number	%	Number(3)	%(4)	%
<b>Directors and Executive Officers:*</b>							
Jun Lei(6)			195,241,483	44.8	195,241,483	17.6	38.8
David Xueling Li(7)	30,000,000	4.5	175,241,483	40.2	205,241,483	18.5	35.4
Qin Liu(8)	40,164,320	6.0			40,164,320	3.6	0.8
Jenny Hong Wei Lee(9)	19,077,920	2.8	40,833,340	9.4	59,911,260	5.4	8.5
Tony Bin Zhao(10)	4,388,601	0.6	16,484,180	3.8	20,872,781	1.9	3.3
Peter Andrew Schloss	**	**			**	**	**
Peng T. Ong	**	**			**	**	**
Richard Weidong Ji	**	**			**	**	**
David Tang	**	**			**	**	**
Rongjie Dong(11)	10,303,570	1.5	1,575,000	0.4	11,878,570	1.1	0.3
Jin Cao	**	**	**	**	**	**	**
Eric He	**	**			**	**	**
All directors and executive officers as a group	106,671,395	15.5	436,181,376	100.0	542,852,771	48.3	88.5
<b>Principal Shareholders:</b>							
Top Brand Holdings Limited(12)							
			195,241,483	44.8	195,241,483	17.6	38.8
YYME Limited(13)	30,000,000	4.5	175,241,483	40.2	205,241,483	18.5	35.4
Granite Global Ventures(14)	19,052,920	2.8	40,833,340	9.4	59,886,260	5.4	8.5

#### Notes:

- \*
- Except for Mr. Jun Lei, Mr. Qin Liu, Ms. Jenny Hong Wei Lee, Mr. Tony Bin Zhao, Mr. Peter Andrew Schloss, Mr. Peng T. Ong, Mr. Richard Weidong Ji, Mr. David Tang and Mr. Rongjie Dong, the business address of our directors and executive officers is c/o Building 3-08, Yangcheng Creative Industry Zone, No. 309 Huangpu Avenue Middle, Tianhe District, Guangzhou, 510655, PRC.
- \*\*
- The aggregate number of common shares beneficially owned by each of these individuals is less than 1% of our total outstanding shares.
- (1)
- For each person and group included in this column, percentage ownership is calculated by dividing the number of Class A common shares beneficially owned by such person or group, including shares that such person or group has the right to acquire within 60 days of February 28, 2014, by the sum of (i) 672,308,738, which is the total number of Class A common shares outstanding as of February 28, 2014, and (ii) the number of Class A common shares that such person or group has the right to acquire within 60 days of February 28, 2014.
- (2)
- For each person and group included in this column, percentage ownership is calculated by dividing the number of Class B common shares beneficially owned by such person or group by 436,181,386, being the total number of Class B common shares outstanding as of February 28, 2014.
- (3)
- Represents the sum of Class A and Class B common shares beneficially owned by such person or group.
- (4)
- For each person and group included in this column, percentage ownership is calculated by dividing the number of total common shares beneficially owned by such person or group, by the sum of the number of common shares outstanding and the number of common shares such person or group



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has the right to acquire upon exercise of the stock options or warrants within 60 days after February 28, 2014.

- (5) For each person or group included in this column, the percentage of total voting power represents voting power based on both Class A and Class B common shares held by such person or group with respect to all of our outstanding Class A and Class B common shares as one class. Each holder of Class A common shares is entitled to one vote per share. Each holder of our Class B common shares is entitled to ten votes per share on all matters requiring a shareholders' vote. Our Class B common shares are convertible at any time by the holder into Class A common shares on a one-for-one basis, whereas Class A common shares are not convertible into Class B common shares under any circumstances.
- (6) Representing 195,241,483 Class B common shares held by Top Brand Holdings Limited, a BVI company wholly owned and controlled by Mr. Jun Lei. The business address of Mr. Lei is Juanshitiandi Tower A, 12th Floor, Chaoyang District, Beijing 100102, PRC.
- (7) Representing (i) 30,000,000 Class A common shares represented by ADSs and (ii) 175,241,483 Class B common shares held by YYME Limited, a BVI company wholly owned and controlled by Mr. David Xueling Li.
- (8) Representing 40,164,320 Class A common shares represented by ADSs held by Morningside China TMT Fund I, L.P. Mr. Qin Liu is a director of our company appointed by Morningside China TMT Fund I, L.P. The business address of Mr. Liu is No. 5, Lane 249, Anfu Road, Shanghai 200031, PRC.
- (9) Representing (i) 18,748,060 Class A common shares represented by ADSs and 40,179,740 Class B common shares held by Granite Global Ventures III L.P., (ii) 304,860 Class A common shares represented by ADSs and 653,600 Class B common shares held by GGV III Entrepreneurs Fund L.P. and (iii) 25,000 restricted share units granted to Ms. Jenny Hong Wei Lee that have fully vested. The business address of Ms. Lee is Unit 3501-3504, Two IFC, 8 Century Avenue, Pudong District, Shanghai 200120, PRC.
- (10) Representing (i) 4,388,601 Class A common shares underlying the restricted shares and restricted share units granted to Mr. Tony Bin Zhao that have fully vested and (ii) 16,484,180 Class B common shares held by YY TZ Limited, a BVI company. YY TZ Limited is ultimately wholly owned by a trust established for the benefit of Mr. Zhao's family. Mr. Zhao is deemed to hold the investment power over the trust. The business address of Mr. Zhao is Room 1902 Building No. 6, No. 1888 Langu Road, Pudong New District, Shanghai, PRC.
- (11) Representing (i) 300,000 Class A common shares represented by ADSs held by Green Leaf Global Limited, (ii) 1,575,000 Class B common shares held by Green Leaf Global Limited and (iii) 10,003,570 Class A common shares underlying the options and restricted shares granted to Mr. Rongjie Dong that have fully vested. The business address of Mr. Dong is 4th floor, Youhua Business Center, Yingbin North Road, Xiangzhou District, Zhuhai 519080, PRC.
- (12) Representing 195,241,483 Class B common shares held by Top Brand Holdings Limited, a BVI company wholly owned and controlled by Mr. Jun Lei. The business address of Top Brand Holdings Limited is c/o Jun Lei, Juanshitiandi Tower A, 12th Floor, Chaoyang District, Beijing 100102, PRC.
- (13) Representing (i) 30,000,000 Class A common shares represented by ADSs and (ii) 175,241,483 Class B common shares held by YYME Limited, a BVI company wholly owned and controlled by Mr. David Xueling Li. The business address of YYME Limited is c/o David Xueling Li, Building 3-08, Yangcheng Creative Industry Zone, No. 309 Huangpu Avenue Middle, Tianhe District, Guangzhou, 510655, PRC.

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(14) Representing (i) 18,748,060 Class A common shares represented by ADSs and 40,179,740 Class B common shares held by Granite Global Ventures III L.P. and (ii) 304,860 Class A common shares represented by ADSs and 653,600 Class B common shares held by GGV III Entrepreneurs Fund L.P. Each of Granite Global Ventures III L.P. and GGV III Entrepreneurs Fund L.P. is controlled by Granite Global Ventures L.L.C., its sole general partner. Scott B. Bonham, Hany M. Nada, Thomas K. Ng, Jixun Foo, Glenn Solomon, Jenny Hong Wei Lee, Fumin Zhuo and Jessie Jin are managing directors of Granite Global Ventures III L.L.C. and are deemed to share the voting and investment power over such shares held by Granite Global Ventures L.L.C. The business address of each of Granite Global Ventures III L.P. and GGV III Entrepreneurs Fund L.P. is 2494 Sand Hill Road, Suite 100, Menlo Park, CA 94025, USA.

As of February 28, 2014, 1,108,490,124 of our common shares were issued and outstanding, including 436,181,386 Class B common shares and 672,308,738 Class A common shares. Based on a review of the register of members maintained by our Cayman Islands registrar, we believe that as of February 28, 2014, 40,833,340 Class B common shares and 672,308,700 Class A common shares (excluding shares being held in reserve by our depository for the exercise/vesting of the share incentive awards we issue) representing approximately 64.3% of our total outstanding shares were held by three record holders in the United States; all of the 57,743,100 Class A common shares were held of record by Deutsche Bank Trust Company Americas, the depository of our ADS program. The number of beneficial owners of our ADSs in the United States is likely to be much larger than the number of record holders of our common shares in the United States. None of our existing shareholders have different voting rights from other shareholders in the same class. See "Item 6. Directors, Senior Management and Employees B. Compensation of Directors and Executive Officers Employee Agreements" for a description of the employment agreements we have entered into with our senior executive officers.

Our common shares are divided into Class A common shares and Class B common shares. Holders of Class A common shares are entitled to one vote per share, while holders of Class B common shares are entitled to ten votes per share.

We are not aware of any arrangement that may, at a subsequent date, result in a change of control of our company.

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**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

**A. Major Shareholders**

Please refer to "Item 6. Directors, Senior Management and Employees E. Share Ownership."

**B. Related Party Transactions**

**Contractual Arrangements**

The PRC government extensively regulates foreign ownership of, and the licensing and permit requirements pertaining to, companies that provide internet-based services such as our YY platform. To comply with these restrictions, we conduct our operations primarily through Beijing Huanju Shidai's contractual arrangements with Beijing Tuda, Guangzhou Huaduo and their respective shareholders.

**Contractual Arrangements with Beijing Tuda**

The following is a summary of the currently effective contracts among our subsidiary, Beijing Huanju Shidai, our PRC consolidated affiliated entity, Beijing Tuda, and the shareholders of Beijing Tuda.

***Agreements that transfer economic benefits to us***

***Exclusive Business Cooperation Agreement***

Under the exclusive business cooperation agreement between Beijing Huanju Shidai and Beijing Tuda, as amended, Beijing Huanju Shidai has the exclusive right to provide to Beijing Tuda technology support, business support and consulting services related to Beijing Tuda's business, the scope of which is to be determined by Beijing Huanju Shidai from time to time. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Beijing Tuda to Beijing Huanju Shidai is up to 100% of the net profit of Beijing Tuda, and the timing and amount of the fee payments shall be determined at the sole discretion of Beijing Huanju Shidai. The term of this agreement will expire in 2039 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai has sole discretion to terminate the agreement at any time by providing 30 days' prior written notice to Beijing Tuda, while neither Beijing Tuda nor its shareholders are entitled to terminate the agreement.

***Exclusive Technology Support and Technology Services Agreement***

Under the exclusive technology support and technology services agreement between Beijing Huanju Shidai and Beijing Tuda, as amended, Beijing Huanju Shidai has the exclusive right to provide to Beijing Tuda technology support and technology services related to all technologies needed for its business. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Beijing Tuda to Beijing Huanju Shidai is 10% of Beijing Tuda's gross revenues. The term of this agreement will expire in 2029 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai has sole discretion to terminate the agreement at any time by providing 30 days' prior written notice to Beijing Tuda, while neither Beijing Tuda nor its shareholders are entitled to terminate the agreement.

***Agreements that provide us effective control over Beijing Tuda***

***Powers of Attorney***

Under the irrevocable powers of attorney executed by each shareholder of Beijing Tuda, each such shareholder appointed Beijing Huanju Shidai as its attorney-in-fact to exercise such shareholders' rights

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in Beijing Tuda, including, without limitation, the power to vote on its behalf on all matters of Beijing Tuda requiring shareholder approval under PRC laws and regulations and the articles of association of Beijing Tuda. Each power of attorney will remain in force until the shareholder ceases to hold any equity interest in Beijing Tuda.

*Exclusive Option Agreement*

Under the exclusive option agreement between Beijing Huanju Shidai, each of the shareholders of Beijing Tuda and Beijing Tuda, each of the shareholders irrevocably granted Beijing Huanju Shidai or its designated representative(s) an exclusive option to purchase, to the extent permitted under PRC law, all or part of his or its equity interests in Beijing Tuda. Beijing Huanju Shidai or its designated representative(s) have sole discretion as to when to exercise such options, either in part or in full. Without Beijing Huanju Shidai's prior written consent, Beijing Tuda's shareholders shall not sell, transfer, mortgage or otherwise dispose their equity interests in Beijing Tuda. The term of this agreement is ten years and may be extended at Beijing Huanju Shidai's sole discretion.

*Equity Interest Pledge Agreement*

Under the equity interest pledge agreement between Beijing Huanju Shidai and the shareholders of Beijing Tuda, the shareholders of Beijing Tuda have pledged all of their equity interests in Beijing Tuda to Beijing Huanju Shidai to guarantee the performance by Beijing Tuda and its shareholders' performance of their respective obligations under the exclusive business cooperation agreement, exclusive option agreement, exclusive technology support and technology services agreement and powers of attorney. If Beijing Tuda or its shareholders breach their contractual obligations under those agreements, Beijing Huanju Shidai, as the pledgee, will be entitled to certain rights, including the right to sell the pledged equity interests. This pledge became effective on the date the pledged equity interests were registered with the competent administration for industry and commerce and will remain effective until the pledgors are no longer the shareholders of Beijing Tuda.

**Contractual Arrangements with Guangzhou Huaduo**

In 2013, we received service fees of RMB31.2 million (US\$5.1 million) from Guangzhou Huaduo. The following is a summary of the currently effective contracts among Beijing Huanju Shidai, Guangzhou Huaduo and the shareholders of Guangzhou Huaduo.

*Agreements that transfer economic benefits to us*

*Exclusive Business Cooperation Agreement*

Under the exclusive business cooperation agreement between Beijing Huanju Shidai and Guangzhou Huaduo, as amended, Beijing Huanju Shidai has the exclusive right to provide to Guangzhou Huaduo technology support, business support and consulting services related to Guangzhou Huaduo's business, the scope of which is to be determined by Beijing Huanju Shidai from time to time. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Guangzhou Huaduo to Beijing Huanju Shidai is up to 100% of the net profit of Guangzhou Huaduo, and the timing and amount of the fee payments will be determined at the sole discretion of Beijing Huanju Shidai. The term of this agreement will expire in 2038 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai has sole discretion to terminate the agreement at any time by providing 30 days' prior written notice to Guangzhou Huaduo, while neither Guangzhou Huaduo nor its shareholders are entitled to terminate the agreement.

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*Exclusive Technology Support and Technology Services Agreement*

Under the exclusive technology support and technology services agreement between Beijing Huanju Shidai and Guangzhou Huaduo, as amended, Beijing Huanju Shidai has the exclusive right to provide to Guangzhou Huaduo technology support and technology services related to all technologies needed for its business. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Guangzhou Huaduo to Beijing Huanju Shidai is 10% of Guangzhou Huaduo's gross revenues. The term of this agreement will expire in 2028 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai has sole discretion to terminate the agreement at any time by providing 30 days' prior written notice to Guangzhou Huaduo, while neither Guangzhou Huaduo nor its shareholders are entitled to terminate the agreement.

***Agreements that provide us effective control over Guangzhou Huaduo***

*Powers of Attorney*

Under the irrevocable powers of attorney executed by each shareholder of Guangzhou Huaduo, each such shareholder appointed Beijing Huanju Shidai as its attorney-in-fact to exercise such shareholders' rights in Guangzhou Huaduo, including, without limitation, the power to vote on its behalf on all matters of Guangzhou Huaduo requiring shareholder approval under PRC laws and regulations and the articles of association of Guangzhou Huaduo. Each power of attorney will remain in force until the shareholder ceases to hold any equity interest in Guangzhou Huaduo.

*Exclusive Option Agreement*

Under the exclusive option agreement between Beijing Huanju Shidai, each of the shareholders of Guangzhou Huaduo and Guangzhou Huaduo, each of the shareholders irrevocably granted Beijing Huanju Shidai or its designated representative(s) an exclusive option to purchase, to the extent permitted under PRC law, all or part of his or its equity interests in Guangzhou Huaduo. Beijing Huanju Shidai or its designated representative(s) have sole discretion as to when to exercise such options, either in part or in full. Without Beijing Huanju Shidai's prior written consent, Guangzhou Huaduo's shareholders shall not sell, transfer, mortgage or otherwise dispose their equity interests in Guangzhou Huaduo. The term of this agreement is ten years and may be extended at Beijing Huanju Shidai's sole discretion.

*Equity Interest Pledge Agreement*

Under the equity interest pledge agreement between Beijing Huanju Shidai and the shareholders of Guangzhou Huaduo, the shareholders of Guangzhou Huaduo have pledged all of their equity interests in Guangzhou Huaduo to Beijing Huanju Shidai to guarantee the performance by Guangzhou Huaduo and its shareholders' performance of their respective obligations under the exclusive business cooperation agreement, exclusive option agreement, exclusive technology support and technology services agreement and powers of attorney. If Guangzhou Huaduo and/or its shareholders breach their contractual obligations under those agreements, Beijing Huanju Shidai, as the pledgee, will be entitled to certain rights, including the right to sell the pledged equity interests. The pledge became effective on the date the pledged equity interests were registered with the competent administration for industry and commerce and will remain effective until the pledgors are no longer the shareholders of Guangzhou Huaduo.

**Transactions with Affiliates**

In July 2010, Guangzhou Huaduo entered into a loan agreement with Zhuhai Daren Computer Technology Company Limited, or Zhuhai Daren, and the shareholders of Zhuhai Daren, pursuant to

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which Guangzhou Huaduo agreed to provide interest-free loans of up to RMB2.0 million in the aggregate to Zhuhai Daren. The amount and timing of drawdown on the loan is at Zhuhai Daren's option. Guangzhou Huaduo holds 30% equity interest in Zhuhai Daren. Zhuhai Daren borrowed RMB1.5 million in 2010 from Guangzhou Huaduo and RMB0.5 million in 2011. As of December 31, 2013, Zhuhai Daren had repaid the loan in full.

Guangzhou Huaduo and Zhuhai Daren had entered into a series of cooperation agreements, under which Guangzhou Huaduo and Zhuhai Daren agreed to cooperate with respect to the operation of certain online games developed by Zhuhai Daren. In the years ended December 31, 2011, 2012 and 2013, the aggregate online game revenues shared from Zhuhai Daren was RMB4.5 million, RMB7.5 million and RMB24.5 million (US\$4.0 million), respectively.

In 2010 and 2011, Guangzhou Huaduo and Guangzhou Shanghang Information Technical Co., Ltd., or Guangzhou Shanghang, entered into certain server co-location agreements, under which Guangzhou Shanghang provides Guangzhou Huaduo with bandwidth and server co-location services in different cities in China. In addition, Guangzhou Huaduo and Guangzhou Shanghang entered into two content delivery network acceleration service agreements, under which Guangzhou Shanghang provides content delivery network acceleration services to Guangzhou Huaduo. Guangzhou Shanghang is 28% owned by Mr. Jun Lei, our co-founder and chairman, including approximately 7% beneficially owned by Mr. David Xuelling Li, our chief executive officer and director. In the years ended December 31, 2011, 2012 and 2013, the bandwidth service that Guangzhou Huaduo acquired from Guangzhou Shanghang were RMB22.0 million, RMB11.8 million and RMB21.3 million (US\$3.5 million), respectively.

Kingsoft Corporation, or Kingsoft, through third party advertising agencies, has in the past placed advertisements on Duowan.com and YY Client and we expect that Kingsoft may continue to do so in the future. We indirectly derived revenues through such third party advertising agencies from Kingsoft in each of the years ended December 31, 2011, 2012 and 2013, which amounted to RMB3.5 million, RMB6.0 million and RMB2.0 million (US\$0.3 million), respectively. In September 2013, Guangzhou Huaduo entered into series of intangible assets purchasing agreements with Kingsoft to acquire patent right and patent application right for certain software, with total consideration of RMB6.0 million (US\$1.0 million). Mr. Jun Lei, our co-founder and chairman, is currently chairman, non-executive director and minority shareholder of Kingsoft.

In January 2011, Guangzhou Huaduo entered into an agreement to invest RMB1.0 million in Zhuhai Qi Ao Yacht Club Co., Ltd., or Zhuhai Qi Ao, which was 100% owned by Mr. Lei. Zhuhai Qi Ao provides professional services and facilities for yacht owners in China. In 2012, we disposed of our 10.0% equity interest in Zhuhai Qi Ao in exchange for a payment of RMB1.0 million from Mr. Lei.

In February 2011, Guangzhou Huaduo entered into an agreement to invest RMB2.5 million in Zhuhai JinShan Kuaikuai Technology Co., Ltd., or JinShan Kuaikuai, which was 100% indirectly owned by Kingsoft. Upon such investment, we own and Kingsoft indirectly owns 20.8% and 62.5% of JinShan Kuaikuai, respectively, with the remaining 16.7% equity interest owned by a third party. JinShan Kuaikuai provides online game technological research services in China.

In 2011 and 2012, Guangzhou Huaduo entered into series of loan agreements with Zhuhai Lequ Technology Co., Ltd., or Zhuhai Lequ, pursuant to which Guangzhou Huaduo provided interest-free loans to Zhuhai Lequ by RMB0.3 million and RMB1.2 million in 2011 and 2012, respectively. Repayment of RMB0.5 million and RMB1.0 million (US\$0.2 million) had been made in 2012 and 2013, respectively. In March 2012 and 2013, Beijing Tuda invested RMB1.0 million and RMB1.0 million (US\$0.2 million) respectively, and then held a 86.96% equity interest in total in, Zhuhai Lequ. We had reduced our equity holding in Zhuhai Lequ to 13.33% by transferring 73.63% of equity interest we held to its founders as of December 31, 2013. In 2013, Guangzhou Huaduo and Zhuhai Lequ entered into a cooperation agreement, under which Guangzhou Huaduo and Zhuhai Lequ agreed to cooperate with



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respect to the operation of certain online games developed by Zhuhai Lequ and the aggregate online game revenues shared from Zhuhai Lequ was RMB5.1 million (US\$0.8 million).

In July 2012, we sold our equity interest in Shenzhen Yingpeng Information Technology Company Limited to Xiaomi Corporation for a cash consideration of RMB2.0 million. In 2013, Zhuhai Duowan and Xiaomi Corporation, entered into certain advertising arrangements where Xiaomi Corporation placed its advertisements on Duowan.com and YY Client in different formats over a particular period of time. We directly derived revenues from Xiaomi Corporation in the year ended December 31, 2013, which amounted to RMB1.2 million (US\$0.2 million). Mr. Lei Jun, our co-founder and chairman, is currently chairman of Xiaomi Corporation.

In December 2013, we made a minority interest investment in Agora, Inc., a company founded by Mr. Tony Bin Zhao, our director and chairman of our technology committee.

**Registration Rights**

We have granted certain registration rights to our shareholders. Set forth below is a description of the registration rights granted under the agreement.

**Demand Registration Rights.** At any time following May 20, 2013, upon a written request from the holders of at least 25% of the registrable securities held by our then preferred shareholders, we shall file a registration statement on a form other than Form F-3 covering the offer and sale of the registrable securities held by the requesting shareholders and other holders of registrable securities who choose to participate in the offering, if the offering covers at least 20% of the then outstanding registrable securities or if the reasonable anticipated offering price to the public, net of selling expenses, would exceed US\$10.0 million. Registrable securities include, among others, our common shares not previously sold to the public and common shares issued or issued upon conversion of the preferred shares.

However, we are not obligated to proceed with a demand registration if we have, within any six-month period, already effected a registration under the Securities Act pursuant to the exercise of the holders' demand registration rights. We have the right to defer filing of a registration statement for up to 90 days if our board of directors determines in good faith that the filing of a registration statement would be materially detrimental to us, but we cannot exercise the deferral right more than once in any 12-month period.

**Form F-3 Registration Rights.** When we are eligible for registration on Form F-3, upon a written request from any holders of the registrable securities held by our then preferred shareholders, we shall file a registration statement on Form F-3 covering the offer and sale of the registrable securities.

We are not obligated to effect a Form F-3 registration, among other things, if we have, within any six-month period, already effected a registration under the Securities Act pursuant to the exercise of the holders' Form F-3 registration rights, or the dollar amount of securities to be sold is of an aggregate price to the public of less than US\$1.0 million. We have the right to defer filing of a registration statement for up to 90 days if our board of directors, including a majority of the directors appointed by the preferred shareholders and Tiger Global Six YY Holdings, determines in good faith that the filing of a registration statement would be materially detrimental to us, but we cannot exercise the deferral right more than once in any 12-month period.

**Piggyback Registration Rights.** If we propose to file a registration statement for a public offering of our common shares on a form that would be suitable only for registrable securities, we must offer holders of registrable securities an opportunity to include in that registration all or any part of their registrable securities. The underwriters of any underwritten offering have the right to limit the number

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of shares with registration rights to be included in the registration statement, subject to certain limitations.

**Expenses of Registration.** We will pay all expenses relating to any demand, Form F-3, or piggyback registration.

**Termination of Obligations.** We shall have no obligation to effect any demand, Form F-3, or piggyback registration (a) five years after our initial public offering, (b) if, in the opinion of counsel to us satisfactory to the holder, all such registrable securities proposed to be sold by a holder may then be sold under Rule 144 or another similar exemption under the Securities Act in one transaction without exceeding the volume limitations thereunder or (c) upon a liquidation event.

**Employment Agreements**

See "Item 6. Directors, Senior Management and Employees B. Compensation of Directors and Executive Officers Employee Agreements" for a description of the employment agreements we have entered into with our senior executive officers.

**Share Incentives**

See "Item 6. Directors, Senior Management and Employees B. Compensation of Directors and Executive Officers" for a description of share-based compensation awards we have granted to our directors, officers and other individuals as a group.

See footnote 21 to our financial statements for further information about our related party transactions.

**C. Interests of Experts and Counsel**

Not applicable.

**ITEM 8. FINANCIAL INFORMATION**

**A. Consolidated Statements and Other Financial Information**

See "Item 18. Financial Statements."

**Legal Proceedings**

We have initiated a lawsuit against Beijing Wonderad Advertisement Co., Ltd., one of our advertisement agents, in Guangzhou in February 2014, claiming for the unpaid advertisement fee and liquidated damages for late payment in the aggregate amount around RMB84 million. Apart from this lawsuit, we are not currently a party to any pending material litigation or other legal proceeding and are not aware of any pending or threatened litigation or other legal proceeding that may have a material adverse impact on our business or operations. However, we may be subject to various legal proceedings and claims that are incidental to our ordinary course of business.

**Dividend Policy**

We have not paid dividend in the past and do not have any present plan to pay any dividend in the foreseeable future. We currently intend to retain most, if not all, of our available funds and any future earnings to operate and expand our business.

We are a holding company incorporated in the Cayman Islands. We may receive dividends from our PRC subsidiary for our cash requirements, including any payment of dividends to our shareholders. PRC regulations may restrict the ability of our PRC subsidiary to pay dividends to us. See "Item 3. Key

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information D. Risk Factors Risks Related to Our Corporate Structure and Our Industry Our PRC subsidiaries and PRC consolidated affiliated entities are subject to restrictions on paying dividends or making other payments to us, which may restrict our ability to satisfy our liquidity requirements" and "Item 4. Information on the Company B. Business Overview PRC Regulation Regulation of Foreign Currency Exchange and Dividend Distribution."

Our board of directors has complete discretion on whether to distribute dividends, subject to the approval of our shareholders. Even if our board of directors decides to pay dividends, the form, frequency and amount will depend upon our future operations and earnings, capital requirements and surplus, general financial condition, contractual restrictions and other factors that the board of directors may deem relevant. If we pay any dividends, we will pay our ADS holders to the same extent as holders of our Class A common shares, subject to the terms of the deposit agreement, including the fees and expenses payable thereunder. See "Item 12. Description of Securities Other than Equity Securities D. American Depositary Shares." Cash dividends on our Class A common shares, if any, will be paid in U.S. dollars.

**B. Significant Changes**

Except as disclosed elsewhere in this annual report, we have not experienced any significant changes since the date of our audited consolidated financial statements included in this annual report.

**ITEM 9. THE OFFER AND LISTING**

**A. Offering and Listing Details**

See " C. Markets" and "Item 12. Description of Securities other than Equity Securities D. American Depositary Shares." We have a dual-class common share structure in which Class A common shares have different voting rights than Class B common shares. Class B common shares are each entitled to ten votes, whereas Class A common shares are each entitled to one vote. See "Item 3. Key Information D. Risk Factors Risks Related to Our ADSs Our dual class common share structure with different voting rights will limit your ability to influence corporate matters and could discourage others from pursuing any change of control transactions that holders of our Class A common shares and ADSs may view as beneficial."

**B. Plan of Distribution**

Not applicable.

Table of Contents**C. Markets**

Our ADSs, each representing twenty Class A common shares, have been listed on the Nasdaq Global Market since November 21, 2012 and trade under the symbol "YY". The following table provides the high and low trading prices for our ADSs on the NASDAQ Global Market for the periods indicated.

	<b>Trading Price</b>	
	<b>High</b>	<b>Low</b>
	<b>US\$</b>	<b>US\$</b>
<b>Annual Highs and Lows</b>		
Fiscal Year 2012 (from November 21, 2012)	15.27	10.50
Fiscal Year 2013	56.75	13.06
<b>Quarterly Highs and Lows</b>		
Fourth Fiscal Quarter of 2012 (from November 21, 2012)	15.27	10.50
First Fiscal Quarter of 2013	20.89	13.06
Second Fiscal Quarter of 2013	30.95	15.52
Third Fiscal Quarter of 2013	51.38	27.10
Fourth Fiscal Quarter of 2013	56.75	41.28
First Fiscal Quarter of 2014 (until March 14, 2014)	90.93	50.00
<b>Monthly Highs and Lows</b>		
September 2013	51.38	39.75
October 2013	55.35	41.28
November 2013	56.75	46.06
December 2013	52.25	46.64
January 2014	72.78	50.00
February 2014	77.90	56.88
March 2014 (until March 14, 2014)	90.93	72.30

**D. Selling Shareholders**

Not applicable.

**E. Dilution**

Not applicable.

**F. Expenses of the Issue**

Not applicable.

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**ITEM 10. ADDITIONAL INFORMATION**

**A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

We are a Cayman Islands company and our affairs are governed by our memorandum and articles of association and the Companies Law 2012 (as amended) of the Cayman Islands, referred to as the Companies Law below. The following are summaries of certain provisions of our memorandum and articles of association in effect as of the date of this annual report insofar as they relate to the material terms of our common shares.

**Registered Office and Objects**

Our registered office in the Cayman Islands is located at Codan Trust Company (Cayman) Limited, Cricket Square, Hutchins Drive, P.O. Box 2681, Grand Cayman, KYI-1111, Cayman Islands. The memorandum of association provides, inter alia, that the liability of the members of our company is limited to the amount, if any, for the time being unpaid on the common shares. The objects for which our company is established are unrestricted (including acting as an investment company), and we shall have and be capable of exercising all the functions of a natural person of full capacity irrespective of corporate benefit, as provided in Section 27(2) of the Companies Law and in view of the fact that we are an exempted Company, we will not trade in the Cayman Islands with any person, firm or corporation except in furtherance of our business carried on outside the Cayman Islands.

**Board of Directors**

See "Item 6. Directors, Senior Management and Employees C. Board Practices Duties of Directors" and " Terms of Directors and Officers."

**Common Shares**

***General***

Our common shares are divided into Class A common shares and Class B common shares. Holders of Class A common shares and Class B common shares will have the same rights except for voting and conversion rights. The holders of ADSs will not be treated as our shareholders and will be required to surrender their ADSs for cancellation and withdrawal from the depository facility in which the Class A common shares are held in accordance with the provisions of the deposit agreement in order to exercise shareholders' rights in respect of the Class A common shares. The depository will agree, so far as it is practical, to vote or cause to be voted the amount of Class A common shares represented by ADSs in accordance with the non-discretionary written instructions of the holders of such ADSs.

All of our outstanding common shares are fully paid and non-assessable. Certificates representing our common shares are issued in the registered form. Our shareholders who are non-residents of the Cayman Islands may freely hold and vote their common shares.

***Meetings***

Shareholders' meetings may be convened by a majority of our board of directors or the chairman. Advance notice in writing of at least ten clear days is required for the convening of our annual general meeting and any other general meeting of our shareholders. A quorum required for a meeting of shareholders consists of at least one or more shareholders present in person or by proxy, or (in the case of a shareholder being a corporation) by its duly authorized representative representing not less

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than one-third in nominal value of the total issued voting shares in our company present throughout the meeting.

Notwithstanding that a meeting is called by shorter notice than that mentioned above, but, subject to the Companies Law, it will be deemed to have been duly called, if it is so agreed (a) in the case of a meeting called as an annual general meeting by all of our shareholders entitled to attend and vote at the meeting; and (b) in the case of any other meeting, by a majority in number of the shareholders having the right to attend and vote at the meeting, being a majority together holding not less than 95% in nominal value of the issued shares giving that right.

No business other than the appointment of a chairman may be transacted at any general meeting unless a quorum is present at the commencement of business. However, the absence of a quorum will not preclude the appointment of a chairman. If present, the chairman of our board of directors shall be the chairman presiding at any shareholders' meetings.

A corporation being a shareholder shall be deemed for the purpose of our articles of association to be present in person if represented by its duly authorized representative being the person appointed by resolution of the directors or other governing body of such corporation to act as its representative at the relevant general meeting or at any relevant general meeting of any class of our shareholders. Such duly authorized representative shall be entitled to exercise the same powers on behalf of the corporation that he represents as that corporation could exercise if it were our individual shareholder.

The quorum for a separate general meeting of the holders of a separate class of shares is described in " Modification of Rights" below.

Our articles of association do not allow our shareholders to approve matters to be determined at shareholders' meetings by way of written resolutions without a meeting.

***Voting Rights***

In respect of all matters requiring a shareholders' vote, each Class A common share is entitled to one vote, and each Class B common share is entitled to ten votes, voting together as one class. At any shareholders' meeting, on a show of hands, every shareholder present in person or by proxy (or, in the case of a shareholder being a corporation, by its duly authorized representative) shall have one vote and on a poll, every shareholder present in person or by proxy, or in the case of a shareholder being a corporation, by its duly authorized representative shall have one vote for each fully paid share of which such shareholder is the holder.

No shareholder shall, unless the Board otherwise determines, be entitled to vote or be reckoned in a quorum, in respect of any share, unless such shareholder is duly registered as our shareholder and all calls or installments due by such shareholder to us have been paid.

If a clearing house (or its nominee(s)) or a central depository entity, being a corporation, is a shareholder, it may authorize such person or persons as it thinks fit to act as its representative(s) at any meeting or at any meeting of any class of shareholders, provided that the authorization shall specify the number and class of shares in respect of which each such person is so authorized. A person so authorized is entitled to exercise the same rights and powers on behalf of the clearing house or central depository entity (or its nominee(s)) as if such person was the registered holder of our shares held by the clearing house or central depository entity (or its nominee(s)) including the right to vote individually on a show of hands.

While there is nothing under the laws of the Cayman Islands which specifically prohibits or restricts the creation of cumulative voting rights for the election of directors of our company, it is not a concept that is accepted as a common practice in the Cayman Islands, and our company has made no provisions in our articles of association to allow cumulative voting for such elections.

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***Conversion***

Each Class B common share is convertible into one Class A common share at any time by the holder thereof. Class A common shares are not convertible into Class B common shares under any circumstances. Upon any transfer of Class B common shares by a holder to any person or entity which is not an affiliate of such holder and which is not any of our founders or any affiliates of our founders, such Class B common shares shall be automatically and immediately converted into the equivalent number of Class A common shares. In addition, if at any time, Messrs. David Xueling Li, Jun Lei, Tony Bin Zhao and Jin Cao and their affiliates collectively beneficially own less than 5% of the total number of the issued and outstanding Class B common shares, each issued and outstanding Class B common share will be automatically and immediately converted into one Class A common share, and we will not issue any Class B common shares thereafter. Furthermore, if at any time more than 50% of the ultimate beneficial ownership of any holder of Class B common shares (other than our founders or our founders' affiliates) changes, each such Class B common share will be automatically and immediately converted into one Class A common share.

***Calls on Shares and Forfeiture of Shares***

Subject to our memorandum and articles of association, our directors may from time to time make such calls upon the members in respect of any amounts unpaid on the shares held by them. The shares that have been called upon and remain unpaid on the specified time are subject to forfeiture.

***Protection of Minority Shareholders***

The Cayman Islands courts ordinarily would be expected to follow English case law precedents which permit a minority shareholder to commence a representative action against or derivative actions in the name of the company to challenge (a) an act which is ultra vires the company or illegal, (b) an act which constitutes a fraud against the minority and regarding which the wrongdoers are themselves in control of the company, and (c) an irregularity in the passing of a resolution which requires a qualified (or special) majority.

In the case of a company (not being a bank) having its share capital divided into shares, the Grand Court of the Cayman Islands may, on the application of members holding not less than one fifth of the shares of the company in issue, appoint an inspector to examine the affairs of the company and to report thereon in such manner as the Grand Court of the Cayman Islands shall direct.

Any of our shareholders may petition the Grand Court of the Cayman Islands which may make a winding up order if the Grand Court of the Cayman Islands is of the opinion that it is just and equitable that we should be wound up or, as an alternative to a winding up order, (a) an order regulating the conduct of our affairs in the future, (b) an order requiring us to refrain from doing or continuing an act complained of by the shareholder petitioner or to do an act which the shareholder petitioner has complained we have omitted to do, (c) an order authorizing civil proceedings to be brought in our name and on our behalf by the shareholder petitioner on such terms as the Grand Court of the Cayman Islands may direct, or (d) an order providing for the purchase of the shares of any of our shareholders by other shareholders or us and, in the case of a purchase by us, a reduction of our capital accordingly.

Generally, claims against us must be based on the general laws of contract or tort applicable in the Cayman Islands or individual rights as shareholders as established by our articles of association.

***Pre-Emption Rights***

There are no pre-emption rights applicable to the issue of new shares of our company under either Cayman Islands law or our memorandum and articles of association.

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***Liquidation Rights***

Subject to any class or classes of shares or future shares which are issued with specific rights, privileges or restrictions as to the distribution of available surplus assets on liquidation, (a) if we are wound up and the assets available for distribution among our shareholders are more than sufficient to repay the whole of the capital paid up at the commencement of the winding up, the excess shall be distributed pari passu among those shareholders in proportion to the amount paid up at the commencement of the winding up on the shares held by them, respectively, and (b) if we are wound up and the assets available for distribution among the shareholders as such are insufficient to repay the whole of the paid-up capital, those assets shall be distributed so that, as nearly as may be, the losses shall be borne by the shareholders in proportion to the capital paid up at the commencement of the winding up on the shares held by them, respectively.

If we are wound up (whether the liquidation is voluntary or by the court), the liquidator may with the sanction of our special resolution and any other sanction required by the Companies Law, divide among our shareholders in specie or kind the whole or any part of our assets (whether or not they shall consist of property of the same kind) and may, for such purpose, set such value as the liquidator deems fair upon any property to be divided and may determine how such division shall be carried out as between the shareholders or different classes of shareholders. The liquidator may also vest the whole or any part of these assets in trustees upon such trusts for the benefit of the shareholders as the liquidator shall think fit, but so that no shareholder will be compelled to accept any assets, shares or other securities upon which there is a liability.

The consideration received by each holder of a Class A common share and a holder of a Class B common share will be the same in any liquidation event.

***Variation of Rights***

Alterations to our memorandum and articles of association may only be made by special resolution, meaning a majority of not less than two-thirds of votes cast at a shareholders' meeting.

If at any time, our share capital is divided into different classes of shares, all or any of the special rights attached to any class of shares may, subject to the provisions of the Companies Law, be varied with the sanction of a special resolution passed at a general meeting of the holders of the shares of that class. Consequently, the rights of any class of shares cannot be detrimentally altered without a majority of two-thirds of the vote of all of the shares in that class. The provisions of our articles of association relating to general meetings shall apply similarly to every such separate general meeting, but so that the quorum for the purposes of any such separate general meeting or at the adjourned meeting shall be a person or persons together holding (or represented by proxy) on the date of the relevant meeting not less than one-third in nominal value of the issued shares of that class, that every holder of shares of the class shall be entitled on a poll to one vote for every such share held by such holder and that any holder of shares of that class present in person or by proxy may demand a poll.

The rights conferred upon the holders of the shares of any class issued with special rights shall not, unless otherwise expressly provided by the terms of issue of the shares of that class, be deemed to be varied by the creation or issue of further shares ranking pari passu with such existing class of shares.

***Alteration of Capital***

We may from time to time by ordinary resolution in accordance with the Companies Law alter the conditions of our memorandum of association to:

increase our capital by such sum, to be divided into shares of such amounts, as the resolution shall prescribe;



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consolidate and divide all or any of our share capital into shares of larger amounts than our existing shares;

cancel any shares which at the date of the passing of the resolution have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled subject to the provisions of the Companies Law;

sub-divide our shares or any of them into shares of smaller amount than is fixed by our memorandum of association, subject nevertheless to the Companies Law, so that the resolution whereby any share is sub-divided may determine that, as between the holders of the shares resulting from such subdivision, one or more of the shares may have any such preferred or other special rights over, or may have such deferred rights or be subject to any such restrictions as compared with the others, as we have power to attach to unissued or new shares; and

divide shares into several classes and without prejudice to any special rights previously conferred on the holders of existing shares, attach to the shares respectively any preferential, deferred, qualified or special rights, privileges, conditions or such restrictions that in the absence of any such determination in a general meeting may be determined by our directors.

We may, by special resolution, subject to any confirmation or consent required by the Companies Law, reduce our share capital or any capital redemption reserve in any manner authorized by law.

*Transfer of Shares*

Subject to any applicable restrictions set forth in our articles of association, including, for example, the board of directors' discretion to refuse to register a transfer of any share (not being a fully paid up share) to a person of whom it does not approve, or any share issued under share incentive plans for employees upon which a restriction on transfer imposed thereby still subsists, or a transfer of any share to more than four joint holders, any of our shareholders may transfer all or any of his or her shares by an instrument of transfer in the usual or common form or in a form prescribed by the Nasdaq Global Market or in another form that our directors may approve.

Our directors may decline to register any transfer of any share which is not paid up or on which we have a lien. Our directors may also decline to register any transfer of any share unless:

the instrument of transfer is lodged with us and is accompanied by the certificate for the shares to which it relates and such other evidence as our directors may reasonably require to show the right of the transferor to make the transfer;

the instrument of transfer is in respect of only one class of share;

the instrument of transfer is properly stamped (in circumstances where stamping is required); and

fee of such maximum sum as the Nasdaq Global Market may determine to be payable or such lesser sum as our directors may from time to time require is paid to us in respect thereof.

If our directors refuse to register a transfer, they shall, within three months after the date on which the instrument of transfer was lodged, send to each of the transferor and the transferee notice of such refusal.

The registration of transfers may, after compliance with any notice requirement of the Nasdaq Global Market, be suspended and the register closed at such times and for such periods as our directors may from time to time determine; provided, however, that the registration of transfers shall not be suspended nor the register closed for more than 30 days in any year as our directors may determine.



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***Register of Members***

In accordance with Section 48 of the Companies Law, the register of members is prima facie evidence of the registered holder or member of shares of a company. Therefore, a person becomes a registered holder or member of shares of the company only upon entry being made in the register of members. Our directors will maintain one register of members, at the office of Codan Trust Company (Cayman) Limited, Cricket Square, Hutchins Drive, P.O. Box 2681, Grand Cayman, KY1-1111, Cayman Islands, which provides us with corporate administrative services. We will perform the procedures necessary to register the shares in the register of members as required in "PART III Distribution of Capital and Liability of Members of Companies and Associations" of the Companies Law, and will ensure that the entries on the register of members are made without any delay.

The depositary will be included in our register of members as the only holder of the Class A common shares underlying the ADSs. The shares underlying the ADSs are not shares in bearer form, but are in registered form and are "non-negotiable" or "registered" shares in which case the shares underlying the ADSs can only be transferred on the books of the company in accordance with Section 166 of the Companies Law.

In the event that we fail to update our register of members, the recourse of investors is directly to the depositary under the terms of the deposit agreement, which is governed by New York law. The depositary will have recourse against us under the terms of the deposit agreement, and also will hold a share certificate evidencing the depositary as the registered holder of shares underlying the ADSs. Further, Section 46 of the Companies Law provides for recourse to be available to our investors in case we fail to update our register of members. In the event we fail to update our register of members, the depositary, as the aggrieved party, may apply for an order with the courts of the Cayman Islands for the rectification of the register of members.

***Share Repurchases***

We are empowered by the Companies Law and our articles of association to purchase our own shares, subject to certain restrictions. Our directors may only exercise this power on our behalf, subject to the Companies Law, our memorandum and articles of association and to any applicable requirements imposed from time to time by the Nasdaq Global Market, the Securities and Exchange Commission, or the SEC, or by any other recognized stock exchange on which our securities are listed.

***Dividends***

Subject to the Companies Law, our company in a general meeting or our directors may declare dividends in any currency to be paid to our shareholders. Dividends may be declared and paid out of our profits, realized or unrealized, or from any reserve set aside from profits which our directors determine is no longer needed. Our board of directors may also declare and pay dividends out of the share premium account or any other fund or account that can be authorized for this purpose in accordance with the Companies Law.

Except in so far as the rights attaching to, or the terms of issue of, any share otherwise provides, (a) all dividends shall be declared and paid according to the amounts paid up on the shares in respect of which the dividend is paid, but no amount paid up on a share in advance of calls shall be treated for this purpose as paid up on that share and (b) all dividends shall be apportioned and paid pro rata according to the amounts paid up on the shares during any portion or portions of the period in respect of which the dividend is paid.

Our directors may also pay interim dividends, whenever our financial position, in the opinion of our directors, justifies such payment.

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Our directors may deduct from any dividend or bonus payable to any shareholder all sums of money (if any) presently payable by such shareholder to us on account of calls or otherwise.

No dividend or other money payable by us on or in respect of any share shall bear interest against us.

In respect of any dividend proposed to be paid or declared on our share capital, our directors may resolve and direct that (a) such dividend be satisfied wholly or in part in the form of an allotment of shares credited as fully paid up, provided that our shareholders entitled thereto will be entitled to elect to receive such dividend (or part thereof if our directors so determine) in cash in lieu of such allotment or (b) the shareholders entitled to such dividend will be entitled to elect to receive an allotment of shares credited as fully paid up in lieu of the whole or such part of the dividend as our directors may think fit. Our shareholders may, upon the recommendation of our directors, by ordinary resolution resolve in respect of any particular dividend that, notwithstanding the foregoing, a dividend may be satisfied wholly in the form of an allotment of shares credited as fully paid up without offering any right to shareholders to elect to receive such dividend in cash in lieu of such allotment.

Any dividend interest or other sum payable in cash to the holder of shares may be paid by check or warrant sent by mail addressed to the holder at his registered address, or addressed to such person and at such addresses as the holder may direct. Every check or warrant shall, unless the holder or joint holders otherwise direct, be made payable to the order of the holder or, in the case of joint holders, to the order of the holder whose name stands first on the register in respect of such shares, and shall be sent at his or their risk and payment of the check or warrant by the bank on which it is drawn shall constitute a good discharge to us.

All dividends unclaimed for one year after having been declared may be invested or otherwise made use of by our board of directors for the benefit of our company until claimed. Any dividend unclaimed after a period of six years from the date of declaration of such dividend shall be forfeited and reverted to us.

Whenever our directors have resolved that a dividend be paid or declared, our directors may further resolve that such dividend be satisfied wholly or in part by the distribution of specific assets of any kind, and in particular of paid up shares, debentures or warrants to subscribe for our securities or securities of any other company. Where any difficulty arises with regard to such distribution, our directors may settle it as they think expedient. In particular, our directors may issue fractional certificates, ignore fractions altogether or round the same up or down, fix the value for distribution purposes of any such specific assets, determine that cash payments shall be made to any of our shareholders upon the footing of the value so fixed in order to adjust the rights of the parties, vest any such specific assets in trustees as may seem expedient to our directors, and appoint any person to sign any requisite instruments of transfer and other documents on behalf of the persons entitled to the dividend, which appointment shall be effective and binding on our shareholders.

***Untraceable Shareholders***

We are entitled to sell any shares of a shareholder who is untraceable, provided that no such sale shall be made unless:

all checks or warrants in respect of dividends of such shares, not being less than three in number, for any sums payable in cash to the holder of such shares have remained un-cashed for a period of 12 years prior to the publication of the advertisement and during the three months referred to in the third bullet point below;

we have not during that time received any indication of the whereabouts or existence of the shareholder or person entitled to such shares by death, bankruptcy or operation of law; and

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we, if so required by the rules of the Nasdaq Global Market, have caused an advertisement to be published in newspapers in accordance with such applicable rules giving notice of our intention to sell these shares, and a period of three months (or such shorter period as permitted under the applicable rules) has elapsed since such advertisement.

The net proceeds of any such sale shall belong to us, and when we receive these net proceeds we shall become indebted to the former shareholder for an amount equal to such net proceeds.

***Inspection of Books and Records***

Holders of our common shares will have no general right under Cayman Islands law to inspect or obtain copies of our list of shareholders or our corporate records. However, we will provide our shareholders with annual audited financial statements.

**C. Material Contracts**

We have not entered into any material contracts other than in the ordinary course of business and other than those described elsewhere in "Item 4. Information on the Company B. Business Overview," "Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions," or elsewhere in this annual report.

**D. Exchange Controls**

See "Item 4. Information on the Company B. Business Overview PRC Regulation Regulation of Foreign Currency Exchange and Dividend Distribution."

**E. Taxation**

**Cayman Islands Taxation**

See "Item 5. Operating and Financial Review and Prospects A. Operating Results Discussion of Selected Statements of Operations Items Taxation Cayman Islands.

**People's Republic of China Taxation**

Under the existing tax laws in the PRC, we are qualified as a non-resident enterprise. We are a holding company incorporated in the Cayman Islands; our holding company indirectly holds 100% of the equity interests in our PRC subsidiaries through Duowan BVI, NeoTask and NeoTask Limited. Our business operations are principally conducted through our PRC subsidiaries and our PRC consolidated affiliated entities. The PRC Enterprise Income Tax Law and its implementation rules, both of which became effective on January 1, 2008, provide that China-sourced income of foreign enterprises, such as dividends paid by a PRC subsidiary to its overseas parent that is not a PRC resident enterprise and has no establishment in the PRC, will normally be subject to PRC withholding tax at a rate of 10%.

If the PRC tax authorities determine that YY Inc., our Cayman Islands holding company, is a PRC resident enterprise for enterprise income tax purposes, our world-wide income could be subject to PRC tax at a rate of 25%, which could materially reduce our net income. In addition, we will also be subject to PRC enterprise income tax reporting obligations. Furthermore, although dividends paid by one PRC tax resident to another PRC tax resident should qualify as "tax-exempt income" under the PRC Enterprise Income Tax Law, we cannot assure you that dividends by our PRC subsidiaries to our Cayman holding company will not be subject to a 10% withholding tax, as the PRC foreign exchange control authorities, which enforce the withholding tax on dividends, and the PRC tax authorities have not yet issued guidance with respect to the processing of outbound remittances to entities that are treated as resident enterprises for PRC enterprise income tax purposes. In addition, ADS holders may be subject to PRC withholding tax on dividends payable by us and gains realized on the sale or other

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disposition of ADSs or common shares, if the PRC tax authorities determine that our Cayman Islands holding company is a PRC resident enterprise for enterprise income tax purposes. See "Risk Factors Risks Related to Doing Business in China Under the PRC enterprise income tax law, we may be classified as a PRC "resident enterprise," which could result in unfavorable tax consequences to us and our shareholders and have a material adverse effect on our results of operations and the value of your investment."

**Material United States Federal Income Tax Considerations**

The following is a summary of the material United States federal income tax considerations relating to the acquisition, ownership, and disposition of our ADSs or common shares by a U.S. holder (as defined below) that will acquire our ADSs or common shares and will hold our ADSs or common shares as "capital assets" (generally, property held for investment) under the United States Internal Revenue Code of 1986, as amended (the "Code"). This summary is based upon existing United States federal income tax law, which is subject to differing interpretations or change, possibly with retroactive effect. This summary does not discuss all aspects of United States federal income taxation that may be important to particular investors in light of their individual investment circumstances, including investors subject to special tax rules (for example, financial institutions, insurance companies, broker-dealers, traders in securities that have elected the mark-to-market method of accounting for their securities, partnerships and their partners, and tax-exempt organizations (including private foundations)), holders who are not U.S. holders, holders who own (directly, indirectly, or constructively) 10% or more of our voting stock, investors that will hold their ADSs or common shares as part of a straddle, hedge, conversion, constructive sale, or other integrated transaction for United States federal income tax purposes, or investors that have a functional currency other than the United States dollar, all of whom may be subject to tax rules that differ significantly from those summarized below. In addition, except to the extent described below, this summary does not discuss any non-United States, state, or local tax considerations or the Medicare tax. Each U.S. holder is urged to consult its tax advisor regarding the United States federal, state, local, and non-United States income and other tax considerations of an investment in our ADSs or common shares.

**General**

For purposes of this summary, a "U.S. holder" is a beneficial owner of our ADSs or common shares that is, for United States federal income tax purposes, (i) an individual who is a citizen or resident of the United States, (ii) a corporation (or other entity treated as a corporation for United States federal income tax purposes) created in, or organized under the law of, the United States or any state thereof or the District of Columbia, (iii) an estate the income of which is includible in gross income for United States federal income tax purposes regardless of its source, or (iv) a trust (A) the administration of which is subject to the primary supervision of a United States court and which has one or more United States persons who have the authority to control all substantial decisions of the trust or (B) that has otherwise elected to be treated as a United States person.

If a partnership (or other entity treated as a partnership for United States federal income tax purposes) is a beneficial owner of our ADSs or common shares, the tax treatment of a partner in the partnership will generally depend upon the status of the partner and the activities of the partnership. Partnerships holding our ADSs or common shares and partners in such partnerships are urged to consult their tax advisors regarding an investment in our ADSs or common shares.

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For United States federal income tax purposes, U.S. holders of ADSs will be treated as the beneficial owners of the underlying shares represented by the ADSs. Accordingly, deposits or withdrawals of common share for ADSs will not be subject to United States federal income tax.

***Passive Foreign Investment Company Considerations***

A non-United States corporation, such as our company, will be classified as a "passive foreign investment company," or "PFIC", for United States federal income tax purposes, for any taxable year, if either (i) 75% or more of its gross income for such year consists of certain types of "passive" income or (ii) 50% or more of its average quarterly assets (as determined on the basis of fair market value) during such year produce or are held for the production of passive income. For this purpose, cash and assets readily convertible into cash are categorized as passive assets and the company's unbooked intangibles are taken into account for determining the value of its assets. We will be treated as owning our proportionate share of the assets and earning our proportionate share of the income of any other corporation in which we own, directly or indirectly, more than 25% (by value) of the stock.

Although the law in this regard is unclear, we treat Guangzhou Huaduo and Beijing Tuda as being owned by us for United States federal income tax purposes, not only because we exercise effective control over the operation of such entities but also because we are entitled to substantially all of their economic benefits, and, as a result, we consolidate their operating results in our consolidated financial statements.

Although we do not believe that we were classified as a PFIC, for United States federal income tax purposes, for the taxable year ended December 31, 2013, there is a risk that we will become a PFIC for our current taxable year ending December 31, 2014 and future taxable years because of our significant cash balances and because the value of our assets, for purposes of the PFIC test, will generally be determined by reference to the market price of our ADSs and common shares. Accordingly, fluctuations in the market price of our ADSs and common shares may cause us to become a PFIC for the current taxable year or future taxable years. It is also possible that the Internal Revenue Service may challenge our classification or valuation of our goodwill and other unbooked intangibles, which may result in our company being or, becoming classified as, a PFIC for the current or future taxable years. The determination of whether we will be or become a PFIC will also depend, in part, upon the nature of our income and assets over time, which are subject to change from year to year. There can be no assurance our business plans will not change in a manner that will affect our PFIC status. Because there are uncertainties in the application of the relevant rules and PFIC status is a fact-intensive determination made on an annual basis, no assurance may be given with respect to our PFIC status for any taxable year.

The discussion below under "Dividends" and "Sale or Other Disposition of ADSs or Common Shares" is written on the basis that we will not be classified as a PFIC for United States federal income tax purposes. The United States federal income tax rules that apply if we are classified as a PFIC for the current taxable year or any subsequent taxable year are generally discussed below under "Passive Foreign Investment Company Rules."

***Dividends***

Subject to the PFIC rules discussed below, any cash distributions (including the amount of any taxes withheld) paid on our ADSs or common shares out of our current or accumulated earnings and profits, as determined under United States federal income tax principles, will generally be includible in the gross income of a U.S. holder as dividend income on the day actually or constructively received by the U.S. holder, in the case of common shares, or by the Depository, in the case of ADSs. Because we do not intend to determine our earnings and profits on the basis of United States federal income tax principles, any distribution paid will generally be reported as a "dividend" for United States federal income tax purposes. A non-corporate recipient of dividend income will generally be subject to tax on

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dividend income from a "qualified foreign corporation" at a reduced United States federal tax rate rather than the marginal tax rates generally applicable to ordinary income provided that certain holding period requirements are met.

A non-United States corporation (other than a corporation that is classified as a PFIC for the taxable year in which the dividend is paid or the preceding taxable year) will generally be considered to be a qualified foreign corporation with respect to any dividend it pays on stock (or ADSs in respect of such stock) which is readily tradable on an established securities market in the United States or, in the event that the company is deemed to be a PRC resident under the PRC Enterprise Income Tax Law, the company is eligible for the benefits of the United States-PRC treaty. Although no assurances may be given, our ADSs are expected to be readily tradable on the Nasdaq Global Market, which is an established securities market in the United States. Since we do not expect that our common shares will be listed on established securities markets, it is unclear whether dividends that we pay on our common shares that are not backed by ADSs currently meet the conditions required for these reduced tax rates. There can be no assurance that our ADSs will be considered readily tradable on an established securities market in the current taxable year or future taxable years.

Dividends received on the ADSs or common shares are not expected to be eligible for the dividends received deduction allowed to corporations. Each U.S. holder is advised to consult its tax advisor regarding the rate of tax that will apply to such holder with respect to dividend distributions, if any, received from us.

Dividends generally will be treated as income from foreign sources for United States foreign tax credit purposes and generally will constitute passive category income. A U.S. holder may be eligible, subject to a number of complex limitations, to claim a foreign tax credit in respect of any foreign withholding taxes imposed on dividends received on ADSs or common shares. A U.S. holder who does not elect to claim a foreign tax credit for foreign tax withheld, may instead claim a deduction, for United States federal income tax purposes, in respect of such withholdings, but only for a year in which such U.S. holder elects to do so for all creditable foreign income taxes. The rules governing the foreign tax credit are complex. Each U.S. holder is advised to consult its tax advisor regarding the availability of the foreign tax credit under their particular circumstances.

***Sale or Other Disposition of ADSs or Common Shares***

Subject to the PFIC rules discussed below, a U.S. holder generally will recognize capital gain or loss upon the sale or other disposition of ADSs or common shares in an amount equal to the difference between the amount realized upon the disposition and the U.S. holder's adjusted tax basis in such ADSs or common shares. Any capital gain or loss will be long-term if the ADSs or common shares have been held for more than one year and will generally be United States source gain or loss for United States foreign tax credit purposes. The deductibility of a capital loss may be subject to limitations. Each U.S. holder is advised to consult its tax advisor regarding the tax consequences if a foreign tax is imposed on a disposition of our ADSs or common shares, including the availability of the foreign tax credit under their particular circumstances.

***Passive Foreign Investment Company Rules***

If we are classified as a PFIC for any taxable year during which a U.S. holder holds our ADSs or common shares, and unless the U.S. holder makes a mark-to-market election (as described below), the U.S. holder will generally be subject to special tax rules that have a penalizing effect, regardless of whether we remain a PFIC, on (i) any excess distribution that we make to the U.S. holder (which generally means any distribution paid during a taxable year to a U.S. holder that is greater than 125% of the average annual distributions paid in the three preceding taxable years or, if shorter, the U.S. holder's holding period for the ADSs or common shares), and (ii) any gain realized on the sale or



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other disposition, including, under certain circumstances, a pledge, of ADSs or common shares. Under the PFIC rules:

such excess distribution and/or gain will be allocated ratably over the U.S. holder's holding period for the ADSs or common shares;

such amount allocated to the current taxable year and any taxable years in the U.S. holder's holding period prior to the first taxable year in which we are classified as a PFIC, or pre-PFIC year, will be taxable as ordinary income;

such amount allocated to each prior taxable year, other than a pre-PFIC year, will be subject to tax at the highest tax rate in effect applicable to the U.S. holder for that year; and

an interest charge generally applicable to underpayments of tax will be imposed on the tax attributable to each prior taxable year, other than a pre-PFIC year.

If we are a PFIC for any taxable year during which a U.S. holder holds our ADSs or common shares and any of our non-United States subsidiaries is also a PFIC, such U.S. holder would be treated as owning a proportionate amount (by value) of the shares of the lower-tier PFIC and would be subject to the rules described above on certain distributions by a lower-tier PFIC and a disposition of shares of a lower-tier PFIC even though such U.S. holder would not receive the proceeds of those distributions or dispositions. Each U.S. holder is advised to consult its tax advisor regarding the application of the PFIC rules to any of our subsidiaries.

As an alternative to the foregoing rules, a U.S. holder of "marketable stock" (as defined below) in a PFIC may make a mark-to-market election for such stock to elect out of the tax treatment discussed above. The mark-to-market election is available only for "marketable stock," which is stock that is traded in other than de minimis quantities on at least 15 days during each calendar quarter ("regularly traded") on a qualified exchange or other market, as defined in applicable United States Treasury regulations. Our ADSs are listed on the NASDAQ, which is a qualified exchange or market for these purposes. We anticipate that our ADSs should qualify as being regularly traded, but no assurances may be given in this regard. Because a mark-to-market election cannot be made for equity interests in any lower-tier PFICs that we own, a U.S. Holder may continue to be subject to the PFIC rules with respect to its indirect interest in any investments held by us that are treated as an equity interest in a PFIC for United States federal income tax purposes. If a mark-to-market election is made, the U.S. holder will generally (i) include as ordinary income for each taxable year that we are a PFIC the excess, if any, of the fair market value of ADSs held at the end of the taxable year over the adjusted tax basis of such ADSs and (ii) deduct as an ordinary loss the excess, if any, of the adjusted tax basis of the ADSs over the fair market value of such ADSs held at the end of the taxable year, but only to the extent of the net amount previously included in income as a result of the mark-to-market election. The U.S. holder's adjusted tax basis in the ADSs would be adjusted to reflect any income or loss resulting from the mark-to-market election.

If a U.S. holder makes a mark-to-market election in respect of a corporation classified as a PFIC and such corporation ceases to be classified as a PFIC, the U.S. holder will not be required to take into account the mark-to-market gain or loss described above during any period that such corporation is not classified as a PFIC.

We do not intend to provide information necessary for U.S. holders to make qualified electing fund elections, which, if available, would result in tax treatment different from (and generally less adverse than) the general tax treatment for PFICs described above.

If a U.S. holder owns our ADSs or common shares during any taxable year that we are a PFIC, such holder is required to file an annual report containing such information as the United States Treasury Department may require and may be required to file an annual IRS Form 8621. Each U.S.

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holder is advised to consult its tax advisors regarding the potential tax consequences to such holder if we are or become classified as a PFIC, including the possibility of making a mark-to-market election.

***Information Reporting and Backup Withholding***

U.S. holders may be subject to information reporting to the Internal Revenue Service with respect to dividends on and proceeds from the sale or other disposition of our ADSs or common shares. Dividend payments with respect to our ADSs or common shares and proceeds from the sale or other disposition of our ADSs or common shares are not generally subject to United States backup withholding (provided that certain certification requirements are satisfied). Each U.S. holder is advised to consult with its tax advisor regarding the application of the United States information reporting and backup withholding rules to their particular circumstances.

Individuals who are U.S. Holders, and who hold "specified foreign financial assets", including stock of a non-U.S. corporation that is not held in an account maintained by a U.S. "financial institution", whose aggregate value exceeds \$50,000 during the tax year, may be required to attach to their tax returns for the year certain specified information. An individual who fails to timely furnish the required information may be subject to a penalty. U.S. Holders who are individuals are urged to consult their tax advisors regarding their reporting obligations under this legislation.

**F. Dividends and Paying Agents**

Not applicable.

**G. Statement by Experts**

Not applicable.

**H. Documents on Display**

We previously filed with the SEC a registration statement on Form F-1 under the Securities Act with respect to our initial public offering of our Class A common shares represented by ADSs.

We are subject to the periodic reporting and other informational requirements of the Securities Exchange Act of 1934 or the Exchange Act. Under the Exchange Act, we are required to file reports and other information with the SEC. Specifically, we are required to file annually a Form 20-F within four months after the end of each fiscal year which is December 31. The SEC maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system. Copies of reports and other information, when filed, may also be inspected without charge and may be obtained at prescribed rates at the public reference facilities maintained by the SEC at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. The public may obtain information regarding the Washington, D.C. Public Reference Room by calling the SEC at 1-800-SEC-0330. As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act.

We will furnish Deutsche Bank Trust Company Americas, the depository of our ADSs, with our annual reports, which will include a review of operations and annual audited consolidated financial statements prepared in conformity with U.S. GAAP, and all notices of shareholders' meetings and other reports and communications that are made generally available to our shareholders. The depository will make such notices, reports and communications available to holders of ADSs and, upon our request, will mail to all record holders of ADSs the information contained in any notice of a shareholders' meeting received by the depository from us.

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**I. Subsidiary Information**

For a listing of our subsidiaries, see "Item 4. Information on the Company C. Organizational Structure."

**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

***Foreign Exchange Risk***

The revenues and expenses of our subsidiaries and PRC consolidated affiliated entities are generally denominated in Renminbi and their assets and liabilities are denominated in Renminbi. Our financing activities are denominated in U.S. dollars.

To date, we have not entered into hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. Although our exposure to foreign exchange risks is generally limited, the value of your investment in our ADSs will be affected by the exchange rate between the U.S. dollar and the Renminbi because the value of our business is effectively denominated in Renminbi, while our ADSs will be traded in U.S. dollars.

The Renminbi is not freely convertible into foreign currencies. Remittances of foreign currencies into the PRC and exchange of foreign currencies into Renminbi require approval by foreign exchange administrative authorities and certain supporting documentation. The State Administration for Foreign Exchange, under the authority of the People's Bank of China, controls the conversion of Renminbi into other currencies.

The value of the Renminbi against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in China's political and economic conditions. The conversion of Renminbi into foreign currencies, including U.S. dollars, is based on rates set by the People's Bank of China. The PRC government allowed the Renminbi to appreciate by more than 20% against the U.S. dollar between July 2005 and July 2008. Between July 2008 and June 2010, this appreciation halted and the exchange rate between the Renminbi and the U.S. dollar remained within a narrow band. Since June 2010, the PRC government has allowed the Renminbi to appreciate slowly against the U.S. dollar again, though there have been periods when the U.S. dollar has appreciated against the Renminbi as well. It is difficult to predict how market forces or PRC or U.S. government policy may impact the exchange rate between the Renminbi and the U.S. dollar in the future. To the extent that we need to convert U.S. dollars we receive from our initial public offering into Renminbi for our operations, appreciation of the Renminbi against the U.S. dollar would have an adverse effect on the Renminbi amount we receive from the conversion. Conversely, if we decide to convert the Renminbi into U.S. dollars for the purpose of making payments for dividends on our common shares or ADSs or for other business purposes, appreciation of the U.S. dollar against the Renminbi would have a negative effect on the U.S. dollar amounts available to us.

***Interest Rate Risk***

Our exposure to interest rate risk primarily relates to the interest income generated by excess cash, which is mostly held in interest-bearing bank deposits. Interest-earning instruments carry a degree of interest rate risk. We have not been exposed to, nor do we anticipate being exposed to, material risks due to changes in market interest rates. However, our future interest income may fall short of expectations due to changes in market interest rates. A hypothetical one percentage point decrease in interest rates would have resulted in a decrease of approximately US\$2.2 million in our interest income for the year ended December 31, 2013.

Table of Contents**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES****A. Debt Securities**

Not applicable.

**B. Warrants and Rights**

Not applicable.

**C. Other Securities**

Not applicable.

**D. American Depositary Shares****Fees and Charges Our ADS holders May Have to Pay**

As an ADS holder, you will be required to pay the following service fees to the depository bank:

<b>Service</b>	<b>Fees</b>
	Up to \$0.05 per ADS issued
Issuance of ADSs, including issuances resulting from a distribution of shares or rights or other property	Up to \$0.05 per ADS cancelled
Cancellation of ADSs, including the case of termination of the deposit agreement	Up to \$0.05 per ADS held
Distribution of cash dividends or other cash distributions	Up to \$0.05 per ADS held
Distribution of ADSs pursuant to share dividends, free share distributions or exercise of rights	A fee equivalent to the fee that would be payable if securities distributed to you had been Class A common shares and the Class A common shares had been deposited for issuance of ADSs
Distribution of securities other than ADSs or rights to purchase additional ADSs	Up to \$0.05 per ADS held on the applicable record date(s) established by the depository bank
Depository services	\$1.50 per certificate presented for transfer

**Transfer of ADSs**

As an ADS holder, you will also be responsible to pay certain fees and expenses incurred by the depository bank and certain taxes and governmental charges (in addition to any applicable fees, expenses, taxes and other governmental charges payable on the deposited securities represented by any of your ADSs), such as:

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Fees for the transfer and registration of Class A common shares charged by the registrar and transfer agent for the Class A common shares in the Cayman Islands (i.e., upon deposit and withdrawal of Class A common shares).

Expenses incurred for converting foreign currency into U.S. dollars.

Expenses for cable, telex and fax transmissions and for delivery of securities.

Taxes and duties upon the transfer of securities, including any applicable stamp duties, any stock transfer charges or withholding taxes (i.e., when Class A common shares are deposited or withdrawn from deposit).

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Fees and expenses incurred in connection with the delivery or servicing of Class A common shares on deposit.

Fees and expenses incurred in connection with complying with exchange control regulations and other regulatory requirements applicable to Class A common shares, deposited securities, ADSs and ADRs.

Any applicable fees and penalties thereon.

The depositary fees payable upon the issuance and cancellation of ADSs are typically paid to the depositary bank by the brokers (on behalf of their clients) receiving the newly issued ADSs from the depositary bank and by the brokers (on behalf of their clients) delivering the ADSs to the depositary bank for cancellation. The brokers in turn charge these fees to their clients. Depositary fees payable in connection with distributions of cash or securities to ADS holders and the depositary services fee are charged by the depositary bank to the holders of record of ADSs as of the applicable ADS record date.

The depositary fees payable for cash distributions are generally deducted from the cash being distributed or by selling a portion of distributable property to pay the fees. In the case of distributions other than cash (i.e., share dividends, rights), the depositary bank charges the applicable fee to the ADS record date holders concurrent with the distribution. In the case of ADSs registered in the name of the investor (whether certificated or uncertificated in direct registration), the depositary bank sends invoices to the applicable record date ADS holders. In the case of ADSs held in brokerage and custodian accounts (via DTC), the depositary bank generally collects its fees through the systems provided by DTC (whose nominee is the registered holder of the ADSs held in DTC) from the brokers and custodians holding ADSs in their DTC accounts. The brokers and custodians who hold their clients' ADSs in DTC accounts in turn charge their clients' accounts the amount of the fees paid to the depositary banks.

In the event of refusal to pay the depositary fees, the depositary bank may, under the terms of the deposit agreement, refuse the requested service until payment is received or may set off the amount of the depositary fees from any distribution to be made to the ADS holder.

**Fees and Other Payments Made by the Depositary to Us**

Deutsche Bank Trust Company Americas, as our depositary, has agreed to reimburse us for a portion of certain expenses we incur that are related to establishment and maintenance of the ADS program, including investor relations expenses. There are limits on the amount of expenses for which the depositary will reimburse us, but the amount of reimbursement available to us is not related to the amounts of fees the depositary collects from investors. Further, the depositary has agreed to reimburse us certain fees payable to the depositary by holders of ADSs. For the year ended December 31, 2013, we received US\$0.8 million from the depositary as reimbursement for our expenses incurred in connection with the establishment and maintenance of our ADS program.

**PART II**

**ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

None.

**ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

See "Item 10. Additional Information" for a description of the rights of securities holders, which remain unchanged.

The following "Use of Proceeds" information relates to the registration statement on Form F-1, as amended (File Number 333-184414) for our initial public offering of 8,970,000 ADSs, representing 179,400,000 Class A common shares, which registration statement was declared effective by the SEC on November 20, 2012. We received net proceeds of US\$82.8 million from our initial public offering.

For the period from the effective date to December 31, 2013, we did not use a substantial portion of the net proceeds received from our initial public offering.

**ITEM 15. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

As required by Rule 13a-15(b) under the Exchange Act, our management, including our chief executive officer, and our chief financial officer, performed an evaluation of the effectiveness of our disclosure controls and procedures, as that term is defined in Rules 13a-15(e) of the Exchange Act, as of the end of the period covered by this annual report. Based on that evaluation, our management has concluded that our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports that we file and furnish under the Exchange Act was recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

**Management's Annual Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with Generally Accepted Accounting Principles (GAAP) in the United States of America and includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of our company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with GAAP, and that receipts and expenditures of our company are being made only in accordance with authorizations of our management and directors; and (3) provide reasonable assurance regarding prevention or timely detection of the unauthorized acquisition, use or disposition of our company's assets that could have a material effect on the consolidated financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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Our management conducted an evaluation of the effectiveness of our company's internal control over financial reporting as of December 31, 2013 based on the framework in Internal Control Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, our management concluded that our internal control over financial reporting was effective as of December 31, 2013.

PricewaterhouseCoopers Zhong Tian LLP, our independent registered public accounting firm, audited the effectiveness of our company's internal control over financial reporting as of December 31, 2013, as stated in its report, which appears on page F-2 of this Form 20-F.

**Changes in Internal Control Over Financial Reporting**

As required by Rule 13a-15(d), under the Exchange Act, our management, including our chief executive officer and our chief financial officer, also conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the period covered by this report have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, it has been determined that there has been no such change during the period covered by this annual report.

**ITEM 16. [RESERVED]****ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our board of directors has determined that Mr. Peter Andrew Schloss is our audit committee financial expert, who is an independent director under the standards set forth in Nasdaq Stock Market Rule 5605(a)(2) and Rule 10A-3 of the Exchange Act. Mr. Schloss is the chairman of our audit committee.

**ITEM 16B. CODE OF ETHICS**

Our board of directors has adopted a code of ethics that applies to our directors, officers, employees and agents, including certain provisions that specifically apply to our chief executive officers, chief financial officer, chief operating officer, vice presidents and any other persons who perform similar functions for us. We filed our code of business conduct and ethics as Exhibit 99.1 to our registration statement on Form F-1, as amended, which was originally filed with the SEC on October 15, 2012 and subsequently amended and filed with this annual report. We have posted a copy of our code of business conduct and ethics on our website at <http://investors.yy.com/governance.cfm>.

**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The following table sets forth the aggregate fees by categories specified below in connection with certain professional services rendered by PricewaterhouseCoopers Zhong Tian LLP, our independent registered public accounting firm, for the years indicated. We did not pay any other fees to our independent registered public accounting firm during the periods other than those indicated below.

	For the Year Ended December 31,	
	2012	2013
	(in RMB thousands)	
Audit fees <sup>(1)</sup>	3,836	9,304
Audit-related fees <sup>(2)</sup>	7,316	

(1)

"Audit fees" means the aggregate fees billed for professional services rendered by our independent registered public accounting firm for the annual audit and the quarterly review of our consolidated



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financial statement. For 2013, the audit refers to the audit of our annual consolidated financial statements and our internal controls over financial reporting.

(2)

"Audit-related fees" means the aggregate fees for professional services rendered by our independent registered public accounting firm that are reasonably related to the audit of our financial statements and our internal controls over financial reporting that are not reported under "Audit Fees". For 2012, the services were rendered in connection with our initial public offering and review and comment on internal control over financial reporting readiness work.

The policy of our audit committee is to pre-approve all audit and non-audit services provided by PricewaterhouseCoopers Zhong Tian LLP, including audit services, audit-related services, tax services and other services as described above, other than those for *de minimis* services which are approved by the audit committee prior to the completion of the audit. Our audit committee has approved all of our audit fees, audit-related fees and tax fees for the year ended December 31, 2013.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

Not applicable.

**ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT**

Not applicable.

**ITEM 16G. CORPORATE GOVERNANCE**

We have followed and intend to continue to follow the applicable corporate governance standards under the Nasdaq Stock Market Rules.

**ITEM 16H. MINE SAFETY DISCLOSURE**

Not applicable.

**PART III**

**ITEM 17. FINANCIAL STATEMENTS**

We have elected to provide financial statements pursuant to Item 18.

**ITEM 18. FINANCIAL STATEMENTS**

The consolidated financial statements of YY Inc. are included at the end of this annual report.

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**ITEM 19. EXHIBITS**

<b>Exhibit Number</b>	<b>Description of Document</b>
1.1	Second Amended and Restated Memorandum and Articles of Association of the Registrant (incorporated herein by reference to Exhibit 3.2 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
2.1	Registrant's Specimen American Depositary Receipt (incorporated herein by reference to Exhibit 4.1 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
2.2	Registrant's Specimen Certificate for Common Shares (incorporated herein by reference to Exhibit 4.2 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
2.3	Form of Deposit Agreement, among the Registrant, the depositary and holder of the American Depositary Receipts (incorporated herein by reference to Exhibit 4.3 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
2.4	Investors' Rights Agreement dated September 6, 2011 among the Registrant and other parties named therein (incorporated herein by reference to Exhibit 4.4 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
2.6	Share Exchange Agreement dated September 6, 2011, relating to Duowan Entertainment Corp. (incorporated herein by reference to Exhibit 4.6 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.1	2009 Employee Equity Incentive Scheme of the Registrant, as amended and restated. (incorporated herein by reference to Exhibit 10.1 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.2	2011 Share Incentive Plan and Amendment No. 1 to the 2011 Share Incentive Plan of the Registrant (incorporated herein by reference to Exhibit 10.2 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.3	Form of Indemnification Agreement with the Registrant's directors and officers (incorporated herein by reference to Exhibit 10.3 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.4	Form of Employment Agreement between the Registrant and an executive officer of the Registrant (incorporated herein by reference to Exhibit 10.4 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)

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<b>Exhibit Number</b>	<b>Description of Document</b>
4.5	English translation of Exclusive Business Cooperation Agreement dated August 12, 2008 between Huanju Shidai (formerly known as Duowan Entertainment Information Technology (Beijing) Company Limited) and Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.5 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.6	English translation of Supplementary Agreement dated November 10, 2011 to Exclusive Business Cooperation Agreement between Huanju Shidai and Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.6 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.7	English translation of Confirmation Letter dated November 10, 2011 to Exclusive Business Cooperation Agreement between Huanju Shidai and Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.7 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.8	English translation of Exclusive Technology Support and Technology Services Agreement dated August 12, 2008 between Huanju Shidai and Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.8 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.9	English translation of Supplementary Agreement dated November 10, 2011 to Exclusive Technology Support and Technology Services Agreement between Huanju Shidai and Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.9 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.10	English translation of Confirmation letter dated November 10, 2011 to Exclusive Technology Support and Technology Services Agreement between Huanju Shidai and Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.10 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.11	English translation of Powers of Attorney dated September 16, 2011 issued to Huanju Shidai by each of the shareholders of Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.11 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.12	English translation of Exclusive Option Agreements dated September 16, 2011 among Huanju Shidai, Guangzhou Huaduo and each of the shareholders of Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.12 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.13	English translation of Equity Interest Pledge Agreements dated September 16, 2011 between Huanju Shidai and each of the shareholders of Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.11 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)

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<b>Exhibit Number</b>	<b>Description of Document</b>
4.14	English translation of Consent Letter dated November 10, 2011 issued by the shareholders of Guangzhou Huaduo (incorporated herein by reference to Exhibit 10.11 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.15	English translation of Exclusive Business Cooperation Agreement dated December 3, 2009 between Huanju Shidai and Beijing Tuda (incorporated herein by reference to Exhibit 10.15 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.16	English translation of Supplementary Agreement dated November 10, 2011 to Exclusive Business Cooperation Agreement between Huanju Shidai and Beijing Tuda (incorporated herein by reference to Exhibit 10.16 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.17	English translation of Confirmation Letter dated November 10, 2011 to Exclusive Business Cooperation Agreement between Huanju Shidai and Beijing Tuda (incorporated herein by reference to Exhibit 10.17 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.18	English translation of Exclusive Technology Support and Technology Services Agreement dated December 3, 2009 between Huanju Shidai and Beijing Tuda (incorporated herein by reference to Exhibit 10.18 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.19	English translation of Supplementary Agreement dated November 10, 2011 to Exclusive Technology Support and Technology Services Agreement between Huanju Shidai and Beijing Tuda (incorporated herein by reference to Exhibit 10.19 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.20	English translation of Confirmation Letter dated November 10, 2011 to Exclusive Technology Support and Technology Services Agreement between Huanju Shidai and Beijing Tuda (incorporated herein by reference to Exhibit 10.20 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.21	English translation of Powers of Attorney dated May 27, 2011 issued to Huanju Shidai by each of the shareholders of Beijing Tuda (incorporated herein by reference to Exhibit 10.21 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.22	English translation of Exclusive Option Agreements dated May 27, 2011 among Huanju Shidai, Beijing Tuda and each of the shareholders of Beijing Tuda (incorporated herein by reference to Exhibit 10.22 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)

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<b>Exhibit Number</b>	<b>Description of Document</b>
4.23	English translation of Equity Interest Pledge Agreements dated July 1, 2011 between Huanju Shidai and each of the shareholders of Beijing Tuda (incorporated herein by reference to Exhibit 10.23 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
4.24	English translation of Consent Letter dated November 10, 2011 issued by the shareholders of Beijing Tuda (incorporated herein by reference to Exhibit 10.24 to the registration statement on Form F-1, as amended (File No. 333-184414), initially filed with the Securities and Exchange Commission on October 15, 2012)
8.1*	List of Subsidiaries and Consolidated Affiliated Entities
11.1	Amended Code of Business Conduct and Ethics of the Registrant (incorporated herein by reference to Exhibit 11.1 to the annual report on Form 20-F (File No. 001-35729) filed with the Securities and Exchange Commission on April 26, 2013)
12.1*	Certification by Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
12.2*	Certification by Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
13.1**	Certification by Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
13.2**	Certification by Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
15.1*	Consent of Conyers Dill & Pearman
15.2*	Consent of Fangda Partners
15.3*	Consent of Independent Registered Public Accounting Firm
101.INS***	XBRL Instance Document
101.SCH***	XBRL Taxonomy Extension Schema Document
101.CAL***	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF***	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB***	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE***	XBRL Taxonomy Extension Presentation Linkbase Document

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\*  
Filed with this annual report on Form 20-F

\*\*  
Furnished with this annual report on Form 20-F

\*\*\*  
XBRL (eXtensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

Date: March 17, 2014

YY INC.

By: /s/ DAVID XUELING LI

\_\_\_\_\_  
Name: David Xueling Li

Title: Director and Chief Executive Officer

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of YY Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and comprehensive income (loss), of changes in shareholders' equity (deficits) and of cash flows, present fairly, in all material respects, the financial position of YY Inc. (the "Company") and its subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's report on Internal Control over Financial Reporting appearing under Item 15 of the accompanying Form 20-F. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

/s/ PricewaterhouseCoopers Zhong Tian LLP  
Shanghai, the People's Republic of China  
March 17, 2014



Table of Contents**CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2012 AND 2013**

(All amounts in thousands, except share, ADS, per share and per ADS data)

	Notes	As of December 31,		
		2012 RMB	2013 RMB	2013 US\$ (Note 2(e))
<b>Assets</b>				
<b>Current assets</b>				
Cash and cash equivalents	5	504,702	729,598	120,521
Short-term deposits	6	897,698	1,432,863	236,692
Accounts receivable, net	7	117,616	100,101	16,536
Amount due from a related party	21	1,073	73	12
Prepayments and other current assets		25,149	67,533	11,156
Deferred tax assets	16	31,549	66,921	11,055
<b>Total current assets</b>		<b>1,577,787</b>	<b>2,397,089</b>	<b>395,972</b>
<b>Non-current assets</b>				
Deferred tax assets	16	583	625	103
Investments	8	2,950	62,029	10,246
Property and equipment, net	9	90,299	102,636	16,954
Intangible assets, net	10	19,481	29,127	4,811
Goodwill	11	1,604	1,577	261
Other non-current assets		3,485	4,864	803
<b>Total non-current assets</b>		<b>118,402</b>	<b>200,858</b>	<b>33,178</b>
<b>Total assets</b>		<b>1,696,189</b>	<b>2,597,947</b>	<b>429,150</b>
<b>Liabilities and shareholders' equity</b>				
<b>Current liabilities</b>				
Accounts payable (including accounts payable of the consolidated variable interest entity without recourse to the Company of RMB27,124 and RMB55,818 as of December 31, 2012 and 2013, respectively)		28,149	56,391	9,315
Deferred revenue (including deferred revenue of the consolidated variable interest entity without recourse to the Company of RMB158,323 and RMB292,380 as of December 31, 2012 and 2013, respectively)	12	159,859	293,866	48,543
Advances from customers (including advances from customers of the consolidated variable interest entity without recourse to the Company of RMB7,271 and RMB10,656 as of December 31, 2012 and 2013, respectively)	2(t)	7,515	19,549	3,229
Income taxes payable (including income taxes payable of the consolidated variable interest entity without recourse to the Company of RMB32,885 and RMB47,974 as of December 31, 2012 and 2013, respectively)		48,001	78,107	12,902

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Accrued liabilities and other current liabilities (including accrued liabilities and other current liabilities of the consolidated variable interest entity without recourse to the Company of RMB81,223 and RMB197,851 as of December 31, 2012 and 2013, respectively)	13	120,289	250,760	41,423
Amounts due to related parties (including amounts due to related parties of the consolidated variable interest entity without recourse to the Company of RMB2,604 and RMB2,640 as of December 31, 2012 and 2013, respectively)	21	2,604	2,640	436
<b>Total current liabilities</b>		<b>366,417</b>	<b>701,313</b>	<b>115,848</b>
<b>Non-current liabilities</b>				
Deferred revenue (including deferred revenue of the consolidated variable interest entity without recourse to the Company of RMB4,525 and RMB8,457 as of December 31, 2012 and 2013, respectively)	12	6,487	9,425	1,557
<b>Total liabilities</b>		<b>372,904</b>	<b>710,738</b>	<b>117,405</b>
<b>Commitments and contingencies</b>	<b>23</b>			

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Table of Contents**CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2012 AND 2013 (Continued)**

(All amounts in thousands, except share, ADS, per share and per ADS data)

	Notes	As of December 31,		
		2012 RMB	2013 RMB	2013 US\$ (Note 2(e))
<b>Shareholders' equity</b>				
Class A common shares (US\$0.00001 par value; 10,000,000,000 shares authorized, 179,400,000 shares issued and outstanding as of December 31, 2012 and 622,658,738 shares issued and outstanding as of December 31, 2013)	17	11	38	6
Class B common shares (US\$0.00001 par value; 1,000,000,000 shares authorized, 907,833,224 shares issued and outstanding as of December 31, 2012 and 485,831,386 shares issued and outstanding as of December 31, 2013)	17	60	34	6
Additional paid-in capital		2,648,404	2,765,614	456,847
Statutory reserves	2(cc)		40,657	6,716
Accumulated deficits		(1,311,767)	(874,697)	(144,490)
Accumulated other comprehensive loss		(13,423)	(44,437)	(7,340)
<b>Total shareholders' equity</b>		1,323,285	1,887,209	311,745
<b>Total liabilities and shareholders' equity</b>		1,696,189	2,597,947	429,150

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

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**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE (LOSS) INCOME  
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**

(All amounts in thousands, except share, ADS, per share and per ADS data)

	Note	For the year ended December 31,			
		2011	2012	2013	2013
		RMB	RMB	RMB	US\$
					(Note 2(e))
<b>Net revenues</b>					
Internet value-added service					
Online music and entertainment		52,854	286,446	852,885	140,887
Online games		165,933	332,287	602,111	99,462
Others		13,589	83,655	205,212	33,899
Online advertising		87,279	117,643	163,260	26,969
<b>Total net revenues</b>		<b>319,655</b>	<b>820,031</b>	<b>1,823,468</b>	<b>301,217</b>
Cost of revenues <sup>(1)</sup>	14	(182,699)	(416,133)	(881,999)	(145,696)
<b>Gross profit</b>		<b>136,956</b>	<b>403,898</b>	<b>941,469</b>	<b>155,521</b>
<b>Operating expenses<sup>(1)</sup></b>					
Research and development expenses		(106,804)	(176,725)	(267,005)	(44,106)
Sales and marketing expenses		(13,381)	(16,954)	(24,955)	(4,122)
General and administrative expenses		(118,241)	(109,788)	(200,554)	(33,129)
<b>Total operating expenses</b>		<b>(238,426)</b>	<b>(303,467)</b>	<b>(492,514)</b>	<b>(81,357)</b>
Other income	15	1,982	2,465	27,078	4,473
<b>Operating (loss) income</b>		<b>(99,488)</b>	<b>102,896</b>	<b>476,033</b>	<b>78,637</b>
Gain on disposal of an equity investment			651		
Gain on disposal of a cost investment			2,351		
Foreign currency exchange gains (losses), net		14,143	(4,153)	29,555	4,882
Interest income		4,890	16,316	60,221	9,948
<b>(Loss) income before income tax expenses</b>		<b>(80,455)</b>	<b>118,061</b>	<b>565,809</b>	<b>93,467</b>
Income tax expenses	16	(1,343)	(29,041)	(89,951)	(14,859)
		<b>(81,798)</b>	<b>89,020</b>	<b>475,858</b>	<b>78,608</b>

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<b>(Loss) income before share of (loss) income in equity method investments, net of income taxes</b>					
Share of (loss) income in equity method investments, net of income taxes		(1,358)	157	1,869	309
<b>Net (loss) income attributable to YY Inc.</b>					
		(83,156)	89,177	477,727	78,917
(Accretion) decretion to convertible redeemable preferred shares redemption value		(223,663)	1,293,875		
Allocation of net income to participating preferred shareholders			(478,754)		
<b>Net (loss) income attributable to common shareholders</b>					
		(306,819)	904,298	477,727	78,917
<b>Net (loss) income</b>					
		(83,156)	89,177	477,727	78,917
Other comprehensive loss:					
Foreign currency translation adjustments, net of nil tax		(11,130)	(1,204)	(31,014)	(5,123)
<b>Comprehensive (loss) income attributable to YY Inc.</b>					
		(94,286)	87,973	446,713	73,794
<b>Net (loss) income per ADS*</b>					
Basic	20	(12.63)	29.91	8.51	1.41
Diluted	20	(12.63)	1.80	8.09	1.34
Weighted average number of ADS used in calculating net (loss) income per ADS					
Basic	20	24,294,192	30,235,191	56,123,784	56,123,784
Diluted	20	24,294,192	49,623,442	59,056,065	59,056,065

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**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE (LOSS) INCOME  
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013 (Continued)**

(All amounts in thousands, except share, ADS, per share and per ADS data)

	Note	For the year ended December 31,			
		2011 RMB	2012 RMB	2013 RMB	2013 US\$ (Note 2(e))
<b>Net (loss) income per common share*</b>					
Basic	20	(0.63)	1.50	0.43	0.07
Diluted	20	(0.63)	0.09	0.40	0.07
Weighted average number of common shares used in calculating net (loss) income per common share					
Basic	20	485,883,845	604,703,810	1,122,475,688	1,122,475,688
Diluted	20	485,883,845	992,468,836	1,181,121,297	1,181,121,297

\*

Each ADS represents 20 Class A common shares.

(1)

Share-based compensation was allocated in cost of revenues and operating expenses as follows:

	Note	For the year ended December 31,			
		2011 RMB	2012 RMB	2013 RMB	2013 US\$ (Note 2(e))
Cost of revenues		15,449	8,407	9,860	1,629
Research and development expenses		31,672	35,441	39,587	6,539
Sales and marketing expenses		1,336	884	1,318	218
General and administrative expenses		86,544	55,619	66,331	10,957

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

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**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' (DEFICITS) EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**

(All amounts in thousands, except share, ADS, per share and per ADS data)

	Notes	Common shares		Additional paid-in capital RMB	Accumulated deficits RMB	Accumulated other comprehensive loss RMB	Total shareholders' deficits RMB
		Number of shares Note 17	Amount RMB				
<b>Balance as of December 31, 2010</b>		466,630,266	32		(2,350,448)	(1,089)	(2,351,505)
Issuance of common shares	17	51,140,432	3	328,129			328,132
Exercise of warrant by an independent institutional investor	17	25,570,216	2	160,835			160,837
Share-based compensation share options	19			2,219			2,219
Share based compensation restricted shares	19			57,805			57,805
Share-based compensation restricted share units	19			9,644			9,644
Share-based compensation warrants to NeoTasks founders	19			3,359			3,359
Share-based compensation restricted shares to the CEO and Chairman	19			14,143			14,143
Transferred from matured liability award for NeoTasks founders	19			57,692			57,692
Reclassification of liability-classified share-based awards into equity-classified awards for warrants to NeoTasks founders	19			57,602			57,602
Reclassification of liability-classified share-based awards into equity-classified awards for share options	19			116,328			116,328
Accretion of Series A convertible redeemable preferred shares to redemption value	18			(88,261)			(88,261)
Accretion of Series B convertible redeemable preferred shares to redemption value	18			(64,102)			(64,102)
Accretion of Series C convertible redeemable preferred shares to redemption value	18			(71,300)			(71,300)
<b>Components of comprehensive loss</b>							
Net loss					(83,156)		(83,156)
Foreign currency translation adjustment, net of nil tax						(11,130)	(11,130)
<b>Balance as of December 31, 2011</b>		543,340,914	37	584,093	(2,433,604)	(12,219)	(1,861,693)

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**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' (DEFICITS) EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013 (Continued)**

(All amounts in thousands, except share, ADS, per share and per ADS data)

	Notes	Class A common shares		Class B Common shares		Additional paid-in capital RMB	Accumulated deficits RMB	Accumulated other comprehensive loss RMB	Total shareholders' (deficits) equity RMB
		Number of shares	Amount	Number of shares	Amount				
		Note 17	RMB	Note 17	RMB				
<b>Balance as of December 31, 2011</b>				543,340,914	37	584,093	(2,433,604)	(12,219)	(1,861,693)
Issuance of common shares	17	179,400,000	11			515,709			515,720
Issuance of common shares for vested restricted shares	17			5,068,000					
Share-based compensation share options	19					(89)			(89)
Share based compensation restricted shares	19					36,371			36,371
Share-based compensation restricted share units	19					54,445			54,445
Share-based compensation restricted shares to the CEO and Chairman	19					9,624			9,624
Transferred from Series A convertible redeemable preferred shares upon the completion of the initial public offering	18			136,100,930	9	449,487			449,496
Transferred from Series B convertible redeemable preferred shares upon the completion of the initial public offering	18			102,073,860	6	337,110			337,116
Transferred from Series C convertible redeemable preferred shares upon the completion of the initial public offering	18			121,249,520	8	400,439			400,447
Decretion of Series A convertible redeemable preferred shares to redemption value	18					125,813	359,704		485,517
Decretion of Series B convertible redeemable preferred shares to redemption value	18					64,102	302,683		366,785
Decretion of Series C convertible redeemable preferred shares to redemption value	18					71,300	370,273		441,573
Components of comprehensive income									
Net income							89,177		89,177
Foreign currency translation adjustment, net of nil tax								(1,204)	(1,204)
<b>Balance as of December 31, 2012</b>		179,400,000	11	907,833,224	60	2,648,404	(1,311,767)	(13,423)	1,323,285



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**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' (DEFICITS) EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013 (Continued)**

(All amounts in thousands, except share, ADS, per share and per ADS data)

	Notes	Class A common shares		Class B Common shares		Additional paid-in capital RMB	Statutory reserves RMB	Accumulated deficits RMB	Accumulated other comprehensive loss RMB	Total shareholders' equity RMB
		Number of shares	Amount	Number of shares	Amount					
		Note 17	RMB	Note 17	RMB					
<b>Balance as of December 31, 2012</b>		179,400,000	11	907,833,224	60	2,648,404		(1,311,767)	(13,423)	1,323,285
Issuance of common shares for exercised share options	17	4,648,420				115				115
Issuance of common shares for vested restricted shares and restricted share units	17	16,608,480	1			(1)				
Class B common shares converted to Class A common shares	17	422,001,838	26	(422,001,838)	(26)					
Share based compensation share options	19					14,004				14,004
Share-based compensation restricted shares	19					7,300				7,300
Share based compensation restricted share units	19					95,792				95,792
Appropriations to statutory reserves	2(cc)						40,657	(40,657)		
Components of comprehensive income										
Net income								477,727		477,727
Foreign currency translation adjustment, net of nil tax									(31,014)	(31,014)
<b>Balance as of December 31, 2013</b>		622,658,738	38	485,831,386	34	2,765,614	40,657	(874,697)	(44,437)	1,887,209

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

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**CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED  
DECEMBER 31, 2011, 2012 AND 2013**

(All amounts in thousands)

	Note	For the year ended December 31,			
		2011 RMB	2012 RMB	2013 RMB	2013 US\$ (Note 2(e))
<b>Cash flows from operating activities</b>					
Net (loss) income		(83,156)	89,177	477,727	78,917
Adjustments to reconcile net (loss) income to net cash provided by operating activities					
Depreciation of property and equipment	9	12,888	29,074	44,963	7,427
Amortization of acquired intangible assets	10	1,211	3,369	4,707	777
Allowance for doubtful accounts	7		6,884	31,987	5,284
(Gain) loss on disposal of property and equipment		(25)	7	1	
Impairment of equity investments				899	148
Impairment of cost investments		1,898	453		
Impairment of intangible assets	10		550		
Share-based compensation	19	135,001	100,351	117,096	19,343
Share of (loss) income in equity method investments		1,358	(157)	(1,869)	(309)
Gain on disposal of an equity investment			(651)		
Gain on disposal of a cost investment			(2,351)		
Deferred income taxes, net	16	(11,173)	(19,316)	(35,414)	(5,850)
Foreign exchange losses (gains), net		(14,143)	4,153	(29,555)	(4,882)
Changes in operating assets and liabilities, net					
Accounts receivable	7	(21,275)	(77,478)	(14,472)	(2,391)
Prepayments and other current and non-current assets		(4,710)	(11,968)	(46,624)	(7,702)
Amounts due from related parties	21		(73)		
Amounts due to related parties	21	(344)	1,734	36	6
Accounts payable		11,196	7,214	26,342	4,351
Deferred revenue	12	23,369	125,541	136,945	22,622
Advances from customers		1,712	5,062	12,034	1,988
Income tax payable		12,516	31,129	30,106	4,973
Accrued liabilities and other current liabilities		33,494	64,148	136,264	22,509
<b>Net cash provided by operating activities</b>		<b>99,817</b>	<b>356,852</b>	<b>891,173</b>	<b>147,211</b>

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**CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED  
DECEMBER 31, 2011, 2012 AND 2013 (Continued)**

(All amounts in thousands)

	Note	For the year ended December 31,			
		2011	2012	2013	2013
		RMB	RMB	RMB	US\$
					(Note 2(e))
<b>Cash flows from investing activities</b>					
Placements of short-term deposits		(872,372)	(1,040,302)	(1,529,090)	(252,588)
Maturities of short-term deposits		399,717	615,259	995,996	164,527
Purchase of property and equipment		(46,956)	(60,881)	(55,606)	(9,185)
Purchase of intangible assets		(274)	(1,920)	(14,631)	(2,417)
Cash paid for equity investments		(4,500)	(1,000)	(11,000)	(1,817)
Cash paid for cost investments	8	(1,000)		(47,110)	(7,782)
Cash received from disposal of a cost investment			1,000	3,000	495
Cash received from disposal of an equity investment			2,000		
Consideration paid in connection with business acquisition	4		(11,722)		
Loan to a related party	21	(500)	(1,200)		
Loan to a third party		(300)			
Repayment of loan from related parties	21		2,500	1,000	165
Loans to employees		(2,770)	(2,930)	(3,770)	(623)
Repayment of loans from employees		197	660	1,560	258
Proceeds from disposal of property and equipment		401	32	48	8
<b>Net cash used in investing activities</b>		<b>(528,357)</b>	<b>(498,504)</b>	<b>(659,603)</b>	<b>(108,959)</b>
<b>Cash flows from financing activities</b>					
Proceeds from issuance of common shares, net of issuance costs	17	488,969			
Proceeds from exercise of vested share options				115	19
Proceeds from initial public offering (net of underwriters' commissions of US\$6,593)	17		550,555		
Payments of listing expenses	17		(27,815)	(5,802)	(958)
Repurchase of share options	19	(11,087)			
<b>Net cash provided by (used in) financing activities</b>		<b>477,882</b>	<b>522,740</b>	<b>(5,687)</b>	<b>(939)</b>
<b>Net increase in cash and cash equivalents</b>		<b>49,342</b>	<b>381,088</b>	<b>225,883</b>	<b>37,313</b>
Cash and cash equivalents at the beginning of the year		83,683	128,891	504,702	83,371
Effect of exchange rate changes on cash and cash equivalents		(4,134)	(5,277)	(987)	(163)
<b>Cash and cash equivalents at the end of the year</b>		<b>128,891</b>	<b>504,702</b>	<b>729,598</b>	<b>120,521</b>
<b>Supplemental disclosure of cash flows information:</b>					
Acquisition of property and equipment in form of accounts payable		1,090	5,911	7,653	1,264
Income taxes paid			(17,228)	(95,259)	(15,736)

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



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**1. Organization and principal activities**

**(a) Principal activities**

YY Inc. (the "Company"), through its subsidiaries, its variable interest entities ("VIEs") and VIE's subsidiary (collectively, the "Group") is principally engaged in operating an online social platform in the People's Republic of China (the "PRC" or "China") through its platform, YY Client and through its website *YY.com* and *Duowan.com*.

**(b) Reorganization**

The Company was incorporated in the Cayman Islands on July 22, 2011.

The Group began its operations in the PRC in April 2005 through its PRC domestic company, Guangzhou Huaduo Network Technology Company Limited ("Guangzhou Huaduo"), which was directly owned by Mr. David Xueling Li (the "Founder" or the "CEO") and Mr. Jun Lei (the "Co-founder" or the "Chairman"). Guangzhou Huaduo holds the necessary licenses and approvals to operate internet-related businesses in the PRC.

For the period between July 2006 and April 2007, the Group undertook a reorganization (the "First Reorganization") and established Duowan Limited ("Duowan Limited"), an investment holding company under the laws of the BVI, Duowan (Hong Kong) Limited ("Duowan (Hong Kong)"), a Hong Kong incorporated company wholly owned by Duowan Limited, and Guangzhou Duowan Information Technology Co., Ltd. ("Guangzhou Duowan"), a wholly-owned foreign enterprise ("WFOE") in the PRC owned by Duowan (Hong Kong) (collectively "Duowan Limited Group Structure"). The First Reorganization was necessary to comply with PRC laws and regulations which prohibit or restrict foreign ownership of companies that provide internet content services in the PRC where licenses are required.

By entering into a series of agreements among the Founder, the Co-founder, Guangzhou Huaduo, and Guangzhou Duowan (collectively, "First VIE agreements"), Guangzhou Huaduo became a VIE of Guangzhou Duowan. Guangzhou Duowan became the primary beneficiary of Guangzhou Huaduo.

In November 2007, Duowan Entertainment Corporation ("Duowan BVI") was incorporated in the British Virgin Islands. In March 2008, Duowan BVI established Duowan Entertainment Information Technology (Beijing) Company Limited ("Duowan Entertainment"), as a WFOE in the PRC and a wholly-owned subsidiary of Duowan BVI. The Group undertook a second reorganization (the "Second Reorganization") whereby the First VIE agreements among the Founder, the Co-founder, Guangzhou Huaduo and Guangzhou Duowan were terminated and a new series of VIE agreements (collectively, "Second VIE agreements") were signed among the Founder, the Co-founder, Guangzhou Huaduo and Duowan Entertainment, through which Duowan Entertainment became the primary beneficiary and exercised effective control over the operations of Guangzhou Huaduo. Duowan BVI became the then holding company of the Group.

In August 2008, Duowan Entertainment purchased all the equity interests in Guangzhou Duowan from Duowan (Hong Kong).

In December 2008, the Group undertook another reorganization (the "Third Reorganization") and acquired all of the equity interests of NeoTasks Inc. ("NeoTasks"), a Cayman Islands company, together with its wholly-owned subsidiary, NeoTasks Limited, its WFOE, NeoTasks International Media Technology (Beijing) Co., Ltd. ("NeoTasks Beijing"), and its VIE, Beijing Tuda Science and Technology Co., Limited ("Beijing Tuda").

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**1. Organization and principal activities (Continued)**

**(b) Reorganization (Continued)**

In July 2009, Guangzhou Duowan was renamed as Zhuhai Duowan Information Technology Co., Ltd. ("Zhuhai Duowan").

In December 2009, another series of VIE agreements (collectively, "Third VIE agreements") were entered into amongst the legal shareholders of Beijing Tuda and Duowan Entertainment and thus completing the Third Reorganization. Through the aforementioned activities, Beijing Tuda became a VIE, whose primary beneficiary is Duowan Entertainment.

In December 2010, Duowan BVI established Zhuhai Duowan Technology Company Limited ("Zhuhai Duowan Technology"), which is directly 100% owned by Duowan BVI.

On September 6, 2011, pursuant to a share swap agreement, all the then existing shareholders of Duowan BVI exchanged their respective shares, including the Series A, Series B, Series C-1 and Series C-2 Preferred Shares, of Duowan BVI for equivalent classes of shares of the Company on a 1 for 1 basis. As a result, Duowan BVI became a wholly-owned subsidiary of the Company and it also became the holding company of the Group (the "Share Swap").

In May 2012, Duowan Entertainment was renamed as Huanju Shidai Technology (Beijing) Company Limited ("Beijing Huanju Shidai").

In September 2012, Zhuhai Duowan Technology was renamed as Guangzhou Huanju Shidai Information Technology Company Limited ("Guangzhou Huanju Shidai").

The First Reorganization, the Second Reorganization, the Third Reorganization and the Share Swap were all reorganization of entities under common control and have been accounted for in a manner akin to a pooling of interest as if the Company, through its wholly owned subsidiaries, had been in existence and been the primary beneficiary of the VIEs throughout the periods presented in the consolidated financial statements. As a result of these arrangements, the Company, through its wholly owned subsidiaries, is considered the primary beneficiary of two VIEs, Guangzhou Huaduo and Beijing Tuda, and accordingly, their results of operation and financial conditions are consolidated in the financial statements of the Group.

**(c) Initial Public Offering**

The Company completed its initial public offering ("IPO") on November 21, 2012 on the NASDAQ Global Market and the underwriters subsequently exercised their over-allotment option on December 5, 2012. The Company issued and sold a total of 8,970,000 American Depositary Shares ("ADSs") in these transactions, representing 179,400,000 Class A common shares. Each ADS represents twenty Class A common shares. The net proceeds received by the Company, after deducting commissions and offering expenses, amounted to approximately US\$82,055. Upon the completion of the IPO, all of the Company's 359,424,310 outstanding preferred shares and 548,408,914 outstanding common shares were converted into Class B common shares immediately as of the same date.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**1. Organization and principal activities (Continued)****(d) Subsidiaries, VIEs and VIE's subsidiary**

The details of the subsidiaries, VIEs and VIE's subsidiary as of December 31, 2013 are set out below:

Name	Place of incorporation	Date of incorporation	% of direct or indirect economic ownership	Principal activities
<b>Subsidiaries</b>				
Duowan Entertainment Corporation ("Duowan BVI")	British Virgin Islands	November 6, 2007	100%	Investment holding
NeoTasks Inc. ("NeoTasks")	Cayman Islands	April 26, 2006	100%	Investment holding
NeoTasks Limited	Hong Kong	June 16, 2005	100%	Investment holding
Huanju Shidai Technology (Beijing) Company Limited ("Beijing Huanju Shidai" or "Duowan Entertainment")	PRC	March 19, 2008	100%	Investment holding
Zhuhai Duowan Information Technology Company Limited ("Zhuhai Duowan" or "Guangzhou Duowan")	PRC	April 9, 2007	100%	Online advertising and software development
Guangzhou Huanju Shidai Information Technology Company Limited ("Guangzhou Huanju Shidai")	PRC	December 2, 2010	100%	Software development
Zhuhai Huanju Shidai Information Technology Company Limited ("Zhuhai Huanju Shidai")	PRC	November 14, 2013	100%	Software development
<b>Variable Interest Entities ("VIEs")</b>				
Guangzhou Huaduo Network Technology Company Limited ("Guangzhou Huaduo")	PRC	April 11, 2005	100%	Holder of internet content provider licenses and internet value added services
Beijing Tuda Science and Technology Company Limited ("Beijing Tuda")	PRC	June 2, 2005	100%	Holder of internet content provider licenses
<b>VIE's Subsidiary</b>				
Guangzhou Juhui Information Technology Company Limited	PRC	October 24, 2013	100%	Software development

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**1. Organization and principal activities (Continued)**

**(e) Variable Interest Entities**

To comply with PRC laws and regulations that prohibit or restrict foreign ownership of companies that provide internet-content, the Group conducts substantially all its operations through Guangzhou Huaduo and Beijing Tuda, which holds the internet value-added service license and approvals to provide such internet services in the PRC. Beijing Huanju Shidai entered into a series of contractual agreements among Beijing Huanju Shidai, Guangzhou Huaduo and their legal shareholders. Beijing Huanju Shidai also entered into a series of contractual agreements among Beijing Huanju Shidai, Beijing Tuda, and Beijing Tuda's legal shareholders.

Guangzhou Huaduo

The Company's relationships with Guangzhou Huaduo and its shareholders are governed by the following contractual arrangements:

Exclusive Technology Support and Technology Services Agreement

Under the exclusive technology support and technology services agreement between Beijing Huanju Shidai and Guangzhou Huaduo, Beijing Huanju Shidai has the exclusive right to provide to Guangzhou Huaduo technology support and technology services related to all technologies needed for its business. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Guangzhou Huaduo to Beijing Huanju Shidai is determined by various factors, including the expenses Beijing Huanju Shidai incurs for providing such services and Guangzhou Huaduo's revenues. The term of this agreement will expire in 2028 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai is entitled to terminate the agreement at any time by providing 30 days' prior written notice to Guangzhou Huaduo.

Exclusive Business Cooperation Agreement

Under the exclusive business cooperation agreement between Beijing Huanju Shidai and Guangzhou Huaduo, Beijing Huanju Shidai has the exclusive right to provide to Guangzhou Huaduo technology support, business support and consulting services related to the services provided by Guangzhou Huaduo, the scope of which is to be determined by Beijing Huanju Shidai from time to time. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Guangzhou Huaduo to Beijing Huanju Shidai is a certain percentage of its earnings. The term of this agreement will expire in 2039 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai is entitled to terminate the agreement at any time by providing 30 days' prior written notice to Guangzhou Huaduo.



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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**1. Organization and principal activities (Continued)**

**(e) Variable Interest Entities (Continued)**

Exclusive Option Agreement

The parties to the exclusive option agreement are Beijing Huanju Shidai, Guangzhou Huaduo and each of the shareholders of Guangzhou Huaduo. Under the exclusive option agreement, each of the shareholders of Guangzhou Huaduo irrevocably granted Beijing Huanju Shidai or its designated representative(s) an exclusive option to purchase, to the extent permitted under PRC law, all or part of his or its equity interests in Guangzhou Huaduo. Beijing Huanju Shidai or its designated representative(s) have sole discretion as to when to exercise such options, either in part or in full. Without Beijing Huanju Shidai's prior written consent, Guangzhou Huaduo's shareholders shall not sell, transfer, mortgage or otherwise dispose their equity interests in Guangzhou Huaduo. The term of this agreement is ten years and may be extended at Beijing Huanju Shidai's sole discretion.

Powers of Attorney

Pursuant to the irrevocable power of attorney executed by each shareholder of Guangzhou Huaduo, each such shareholder appointed Beijing Huanju Shidai as its attorney-in-fact to exercise such shareholders' rights in Guangzhou Huaduo, including, without limitation, the power to vote on its behalf on all matters of Guangzhou Huaduo requiring shareholder approval under PRC laws and regulations and the articles of association of Guangzhou Huaduo. Each power of attorney will remain in force until the shareholder ceases to hold any equity interest in Guangzhou Huaduo.

Share Pledge Agreement

Pursuant to the share pledge agreement between Beijing Huanju Shidai and the shareholders of Guangzhou Huaduo, the shareholders of Guangzhou Huaduo have pledged all of their equity interests in Guangzhou Huaduo to Beijing Huanju Shidai to guarantee the performance by Guangzhou Huaduo and its shareholders' performance of their respective obligations under the exclusive business cooperation agreement, exclusive option agreement, exclusive technology support and technology services agreement and powers of attorney. If Guangzhou Huaduo and/or its shareholders breach their contractual obligations under those agreements, Beijing Huanju Shidai, as pledgee, will be entitled to certain rights, including the right to sell the pledged equity interests.

Beijing Tuda

The Company's relationships with Beijing Tuda and its shareholders are governed by the following contractual arrangements:

Exclusive Technology Support and Technology Services Agreement

Pursuant to the exclusive technology support and technology services agreement between Beijing Huanju Shidai and Beijing Tuda, Beijing Huanju Shidai has the exclusive right to provide to Beijing Tuda technology support and technology services related to all technologies needed for its business. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Beijing Tuda to Beijing Huanju Shidai is determined by various factors, including the expenses Beijing Huanju Shidai incurs for providing such services and Beijing Tuda's revenues. The term of this agreement will expire in 2029 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai is entitled to terminate the agreement at any time by providing 30 days' prior written notice to Beijing Tuda.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**1. Organization and principal activities (Continued)**

**(e) Variable Interest Entities (Continued)**

Exclusive Business Cooperation Agreement

Pursuant to the exclusive business cooperation agreement between Beijing Huanju Shidai and Beijing Tuda, Beijing Huanju Shidai has the exclusive right to provide to Beijing Tuda technology support, business support and consulting services related to the services provided by Beijing Tuda, the scope of which is to be determined by Beijing Huanju Shidai from time to time. Beijing Huanju Shidai owns the exclusive intellectual property rights created as a result of the performance of this agreement. The service fee payable by Beijing Tuda to Beijing Huanju Shidai is a certain percentage of its earnings. The term of this agreement will expire in 2039 and may be extended with Beijing Huanju Shidai's written confirmation prior to the expiration date. Beijing Huanju Shidai is entitled to terminate the agreement at any time by providing 30 days' prior written notice to Beijing Tuda.

Exclusive Option Agreement

The parties to the exclusive option agreement are Beijing Huanju Shidai, Beijing Tuda and each of the shareholders of Beijing Tuda. Under the exclusive option agreement, each of the shareholders of Beijing Tuda irrevocably granted Beijing Huanju Shidai or its designated representative(s) an exclusive option to purchase, to the extent permitted under PRC law, all or part of his or its equity interests in Beijing Tuda. Beijing Huanju Shidai or its designated representative(s) have sole discretion as to when to exercise such options, either in part or in full. Without Beijing Huanju Shidai's prior written consent, Beijing Tuda's shareholders shall not sell, transfer, mortgage or otherwise dispose their equity interests in Beijing Tuda. The term of this agreement is ten years and may be extended at Beijing Huanju Shidai's sole discretion.

Powers of Attorney

Pursuant to the irrevocable power of attorney executed by each shareholder of Beijing Tuda, each such shareholder appointed Beijing Huanju Shidai as its attorney-in-fact to exercise such shareholders' rights in Beijing Tuda, including, without limitation, the power to vote on its behalf on all matters of Beijing Tuda requiring shareholder approval under PRC laws and regulations and the articles of association of Beijing Tuda. Each power of attorney will remain in force until the shareholder ceases to hold any equity interest in Beijing Tuda.

Share Pledge Agreement

Under the share pledge agreement between Beijing Huanju Shidai and the shareholders of Beijing Tuda, the shareholders of Beijing Tuda have pledged all of their equity interests in Beijing Tuda to Beijing Huanju Shidai to guarantee the performance by Beijing Tuda and its shareholders' performance of their respective obligations under the exclusive business cooperation agreement, exclusive option agreement, exclusive technology support and technology services agreement and powers of attorney. If Beijing Tuda or its shareholders breach their contractual obligations under those agreements, Beijing Huanju Shidai, as pledgee, will be entitled to certain rights, including the right to sell the pledged equity interests.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**1. Organization and principal activities (Continued)**

**(e) Variable Interest Entities (Continued)**

Through the aforementioned contractual agreements, Guangzhou Huaduo and Beijing Tuda are considered VIEs in accordance with Generally Accepted Accounting Principles in the United States ("US GAAP") because the Company, through Beijing Huanju Shidai has the ability to:

exercise effective control over Guangzhou Huaduo or Beijing Tuda;

receive substantially all of the economic benefits and residual returns, and absorb substantially all the risks and expected losses from VIEs as if it were their sole shareholder; and

have an exclusive option to purchase all of the equity interests in the VIEs.

Management evaluated the relationships among the Company, Beijing Huanju Shidai, the VIEs and concluded that Beijing Huanju Shidai is the primary beneficiary of the VIEs. As a result, the VIEs' results of operations, assets and liabilities have been included in the Company's consolidated financial statements. The adoption of the new consolidation guidance effective January 1, 2010 did not change the Group's conclusions on consolidation.

As of December 31, 2013, the total assets of the consolidated VIEs and VIE's subsidiary were RMB1,443,127, mainly comprising cash and cash equivalents, short-term deposits, accounts receivable, prepayments and other current assets, investment, property and equipment, intangible assets and deferred tax assets. As of December 31, 2013, the total liabilities of the consolidated VIEs and VIE's subsidiary were RMB615,776, mainly comprising accounts payable, deferred revenue, accrued liabilities and other current liabilities, income taxes payable and advances from customers.

In accordance with the aforementioned agreements, the Company has power to direct activities of the VIEs, and can have assets transferred out of the VIEs. Therefore the Company considers that there is no asset in the consolidated VIEs and VIE's subsidiary that can be used only to settle obligations of the consolidated VIEs and VIE's subsidiary, except for registered capital and PRC statutory reserves of the VIEs and VIE's subsidiary amounting to RMB241,657 as of December 31, 2013. As the consolidated VIEs and VIE's subsidiary were incorporated as limited liability companies under the PRC Company Law, the creditors do not have recourse to the general credit of the Company for all the liabilities of the consolidated VIEs and VIE's subsidiary.

Currently there is no contractual arrangement that could require the Company to provide additional financial support to the VIEs. As the Company is conducting its PRC internet value-added services business through the VIEs, the Company will, if needed provide such support on a discretionary basis in the future, which could expose the Company to a loss.

There is no VIE where the Company has variable interest but is not the primary beneficiary.

**(f) Share Split**

On December 23, 2009, the board of directors of Duowan BVI approved a 1 to 490 share split of all of its outstanding common shares and a proportional adjustment to the existing conversion ratios for each series of preferred shares. Accordingly, all share, share option and per share amounts for all periods presented in these consolidated financial statements and notes thereto, have been adjusted retrospectively, where applicable, to reflect this share split and adjustment of the preferred shares conversion ratio.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies**

**(a) Basis of presentation**

The consolidated financial statements have been prepared on a historical cost basis to reflect the financial position and results of operations of the Group in accordance with the US GAAP.

**(b) Consolidation**

The Group's consolidated financial statements include the financial statements of the Company, its subsidiaries, and its VIEs and VIE's subsidiary for which the Company or its subsidiary is the primary beneficiary. All transactions and balances among the Company, its subsidiaries, its VIEs and VIE's subsidiary have been eliminated upon consolidation.

The First Reorganization, the Second Reorganization and the Third Reorganization, as described in Note 1 have been accounted for at historical costs. The assets and liabilities of Guangzhou Huaduo and its subsidiary, and Beijing Tuda are consolidated in the Company's financial statements at carryover basis. The accompanying consolidated statements of operations and comprehensive (loss) income and consolidated statements of cash flows include the results of operations and cash flows of the Group as if the current group structure had been in existence throughout the years ended December 31, 2011, 2012 and 2013, or since their respective dates of incorporation. The accompanying consolidated balance sheets have been prepared to present the financial position of the Group as of December 31, 2012 and 2013 as if the current group structure had been in existence as of these dates.

A subsidiary is an entity in which the Company, directly or indirectly, controls more than one half of the voting powers; or has the power to appoint or remove the majority of the members of the board of directors; or to cast a majority of votes at the meeting of directors; or has the power to govern the financial and operating policies of the investee under a statute or agreement among the shareholders or equity holders.

A VIE is an entity in which the Company, or its subsidiary, through contractual agreements, bears the risks of, and enjoys the rewards normally associated with ownership of the entity, and therefore the Company or its subsidiary is the primary beneficiary of the entity. In determining whether the Company or its subsidiaries are the primary beneficiary, the Company considered whether it has the power to direct activities that are significant to the VIEs economic performance, and also the Company's obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Beijing Huanju Shidai and ultimately the Company holds all the variable interests of the VIEs and has been determined to be the primary beneficiary of the VIEs.

**(c) Use of estimates**

The preparation of the Company's consolidated financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from such estimates. The Company believes that lives of the game and lives of the user relationship related to online games revenue, the determination of estimated selling prices of multiple element revenue contracts, sales rebate to advertising agencies, income taxes, allowances for doubtful accounts, determination of share-based compensation expenses, impairment assessment of goodwill, long-lived assets and intangible assets, represent critical accounting policies that reflect more significant judgments and estimates used in the preparation of its consolidated financial statements.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(c) Use of estimates (Continued)**

Management bases the estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from these estimates.

**(d) Foreign currency translation**

The Group uses Renminbi ("RMB") as its reporting currency. The functional currency of the Company and its subsidiaries incorporated in the Cayman Islands, British Virgin Islands, and Hong Kong is United States dollar ("US\$"), while the functional currency of the other entities, VIEs and VIE's subsidiary in the Group is RMB, which is their respective local currency. In the consolidated financial statements, the financial information of the Company and its subsidiaries, which use US\$ as their functional currency, have been translated into RMB. Assets and liabilities are translated at the exchange rates on the balance sheet date, equity amounts are translated at historical exchange rates, and revenues, expenses, gains, and losses are translated using the average exchange rate for the period. Translation adjustments arising from these are reported as foreign currency translation adjustments and are shown as a component of other comprehensive income or loss in the statement of operations and comprehensive (loss) income.

Foreign currency transactions denominated in currencies other than functional currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are remeasured at the applicable rates of exchange in effect at that date. Foreign exchange gains and losses resulting from the settlement of such transactions and from remeasurement at year-end are recognized in foreign currency exchange gains (losses), net in the consolidated statement of operations.

**(e) Convenience translation**

Translations of amounts from RMB into US\$ for the convenience of the reader were calculated at the noon buying rate of US\$1.00 = RMB6.0537 on December 31, 2013 as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. No representation is made that the RMB amounts could have been, or could be, converted into US\$ at such rate.

**(f) Fair value of financial instruments**

The Group's financial instruments consist principally of cash and cash equivalents, short-term deposits, accounts receivable, other receivables, amounts due from (to) related parties, accounts payable and other payables. The carrying values of these balances approximate their fair values due to the current and short-term nature of these balances.

**(g) Cash and cash equivalents**

Cash includes currency on hand and deposits held by financial institutions that can be added to or withdrawn without limitation. Cash equivalents represent short-term and highly liquid investments placed with banks, which have both of the following characteristics:

- i) Readily convertible to known amounts of cash throughout the maturity period;
- ii) So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(h) Short-term deposits**

Short-term deposits represent time deposits placed with banks with original maturities of less than one year. Interest earned is recorded as interest income in the consolidated statements of operations during the periods presented.

**(i) Accounts receivable, net**

Accounts receivable are presented net of allowance for doubtful accounts. The Group uses specific identification in providing for bad debts when facts and circumstances indicate that collection is doubtful and a loss is probable and estimable. If the financial conditions of its customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowance may be required.

The Company reviews on a periodic basis for doubtful accounts based on historical experience and information available. Additionally, the Company makes specific bad debt provisions based on (i) its specific assessment of the collectability of all significant accounts; and (ii) any specific knowledge the Company has acquired that might indicate that an account is uncollectible. The facts and circumstances of each account may require the Company to use substantial judgment in assessing its collectability.

**(j) Equity investment**

The equity investment is comprised of investments in privately-held companies. The Group accounts for its equity investment over which it has significant influence but does not own a majority equity interest or otherwise control using the equity method. The Group assesses its equity investment for other-than-temporary impairment by considering factors including, but not limited to, current economic and market conditions, operating performance of the companies, including current earnings trends and undiscounted cash flows, and other company-specific information. The fair value determination, particularly for investment in privately-held companies, requires judgment to determine appropriate estimates and assumptions. Changes in these estimates and assumptions could affect the calculation of the fair value of the investment and determination of whether any identified impairment is other-than-temporary.

**(k) Cost investment**

The cost investment is comprised of investments in privately-held companies. The Group accounts for cost investment which has no readily determinable fair value using the cost method. Under the cost method, the investment is measured initially at cost. The investment carried at cost should recognize income when dividends are received from the distribution of the investee's earnings. The Group periodically evaluates the carrying value of investments accounted for under the cost method of accounting and any impairment is included in the consolidated statements of operations.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(l) Property and equipment**

Property and equipment are stated at historical cost less accumulated depreciation and impairment loss, if any. Depreciation is calculated using the straight-line method over their estimated useful lives. Residual rate is determined based on the economic value of the equipment at the end of the estimated useful lives as a percentage of the original cost.

	Estimated useful lives	Residual rate
Servers, computers and equipment	3 years	0%-5%
Furniture, fixture and office equipment	5 years	0%-5%
Motor vehicles	4 years	5%
Leasehold improvement	Shorter of lease term or 5 years	

Expenditures for maintenance and repairs are expensed as incurred. The gain or loss on the disposal of property and equipment is the difference between the net sales proceeds and the carrying amount of the relevant assets and is recognized in the consolidated statements of operations.

All direct and indirect costs that are related to the construction of property and equipment and incurred before the assets are ready for their intended use are capitalized as construction in progress. Construction in progress is transferred to specific property and equipment items and depreciation of these assets commences when they are ready for their intended use.

**(m) Business combinations**

The Group accounts for acquisitions of entities that include inputs and processes and have the ability to create outputs as business combinations. The Group allocates the purchase price of the acquisition to the tangible assets, liabilities, and identifiable intangible assets acquired based on their estimated fair values. The excess of the purchase price over those fair values is recorded as goodwill. Acquisition-related costs generally are expensed as incurred.

**(n) Intangible assets, net**

Intangible assets mainly consist of software and domain names purchased from third parties. Identifiable intangible assets are carried at acquisition cost less accumulated amortization and impairment loss, if any. Finite-lived intangible assets are tested for impairment if impairment indicators arise. Amortization of finite-lived intangible assets is computed using the straight-line method over the following estimated useful lives, which are as follows:

	Estimated useful lives
Software	3-5 years
Technology	5 years
Domain name	15 years

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(o) Impairment of long-lived assets**

For other long-lived assets including amortizable intangible assets and property and equipment, the Group evaluates for impairment whenever events or changes (triggering events) indicate that the carrying amount of an asset may no longer be recoverable. The Group assesses the recoverability of the long-lived assets by comparing the carrying value of the long-lived assets to the estimated undiscounted future cash flows expected to receive from use of the assets and their eventual disposition. Such assets are considered to be impaired if the sum of the expected undiscounted cash flows is less than the carrying amount of the assets. The impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

**(p) Goodwill**

Goodwill represents the excess of the purchase price over the amounts assigned to the fair value of the assets acquired and the liabilities assumed of an acquired business.

**(q) Annual test for impairment of goodwill**

Goodwill assessment for impairment is performed on at least an annual basis on October 1 or whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. The Group performs a two-step goodwill impairment test. The first step compares the fair values of each reporting unit to its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill is not considered impaired and the second step will not be required. If the carrying amount of a reporting unit exceeds its fair value, the second step compares the implied fair value of the affected reporting unit's goodwill to the carrying value of that goodwill. The implied fair value of goodwill is determined in a manner similar to accounting for a business combination with the allocation of the assessed fair value determined in the first step to the assets and liabilities of the reporting unit. The excess of the fair value of the reporting unit over the amounts assigned to the assets and liabilities is the implied fair value of goodwill. This allocation process is only performed for purposes of evaluating goodwill impairment and does not result in an entry to adjust the value of any assets or liabilities. An impairment loss is recognized for any excess in the carrying value of goodwill over the implied fair value of goodwill. The judgment in estimating the fair value of reporting units includes estimating future cash flows, determining appropriate discount rates and making other assumptions. Changes in these estimates and assumptions could materially affect the determination of the fair value of each reporting unit.

No goodwill impairment losses were recognized for the years ended December 31, 2011, 2012 and 2013.

**(r) Operating leases**

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating lease are charged to the consolidated statements of operations on a straight-line basis over the period of the lease.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(s) Revenue recognition**

The Group generates revenues from internet value-added services ("IVAS") and online advertising. Revenues from IVAS are generated from online music and entertainment, online games, membership subscription fees and other IVAS. Online advertising revenues are primarily generated from sales of different forms of advertising on the Group's platform. Revenue is recognized when persuasive evidence of an arrangement exists, service has been rendered, the price is fixed or determinable and collection is reasonably assured. Revenue is deferred until these criteria are met as described below.

**(i)****Internet value-added services**

The Group operates a virtual currency system, under which, the users can directly purchase virtual currency, virtual items on YY Client's online community channels or pay membership subscription fees via online payment systems provided by third parties including payments using mobile phone, internet debit/credit card payment and other third party payment systems. The virtual currency can be converted into game tokens that can be used to purchase virtual items in online games (both developed by third parties and self-developed), or used directly to purchase virtual items on YY Client's online community channels or used to pay membership subscription fees. Virtual currency sold but not yet consumed by the purchasers is recorded as "Advances from customers" and upon conversion or being used, is recognized as revenue according to the respective prescribed revenue recognition policies addressed below:

**(1)****Online music and entertainment revenue**

The Group creates and offers virtual items to be used by users on online music and entertainment channels, which the Group operates and maintains. The virtual items are offered free of charge or sold to users at different specified prices as pre-determined by the Company. Online music and entertainment revenue consists of sales of virtual items. Users purchase consumable virtual items from the Group and present them to performers to show support for their favorite performers or time-based virtual items, which provide users with recognized status, such as priority speaking rights or special symbols on the music channels for a specific period of time. In order to attract user traffic, the Group shares with certain popular performers and channel owners, who have entered into revenue sharing arrangements with the Group, a portion of the revenues the Group derives from such in-channel virtual item sales on online music and entertainment channels, which the Group accounts for as cost of revenues. Performers and channel owners, who do not have revenue sharing arrangements with the Group, are not entitled to share any revenue derived from the virtual items sold. The Group does not recognize any revenue from offering free virtual items nor share any revenue with performers or channel owners when free virtual items are presented to performers by the users. Accordingly, online music and entertainment revenue is recognized for the sale of virtual items sold in online music and entertainment channels immediately if the virtual item is a consumable or, in the case of time-based virtual items, recognized ratably over the period each virtual item is made available to the user, which does not exceed one year. The Group does not have further obligations to the user after the virtual items are consumed. Virtual items may be sold individually or bundled into one arrangement. When the Group's users purchase multiple virtual items bundled within the same arrangement, the Group evaluates such arrangements under ASC 605-25 Multiple-Element Arrangements. The Group identifies individual elements under the arrangement and determines if such elements meet the criteria to be accounted for as separate units of accounting. The Group

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(s) Revenue recognition (Continued)****(i)****Internet value-added services (Continued)****(1)****Online music and entertainment revenue (Continued)**

allocates the arrangement consideration to the separate units of accounting based on their relative selling price. The following hierarchy has been followed when determining the relative selling price for each element: (1) vendor specific objective evidence ("VSOE"), (2) third party evidence ("TPE"), and (3) best estimate of selling price ("BESP"). Given that the VSOE of the selling price cannot be determined, the Group has adopted a policy to allocate the consideration of the whole arrangement to different virtual item elements based on the TPE of selling price or the BESP for each virtual item element. The Group determines the fair values of virtual items sold in a bundle based on similar products sold separately on the YY platform based on the TPE of the selling price and determines the fair values of virtual items without similar products sold separately on the YY platform based on the BESP. The BESP is generally based on the selling prices of the various elements of a similar nature when they are sold to users on a stand-alone basis. The BESP may also be based on an estimated stand-alone pricing when the element has not previously been sold on a stand-alone basis.

These estimates are generally determined based on pricing strategies, market factors and strategic objectives. The Group recognizes revenue for each virtual item element in accordance with the applicable revenue recognition method.

**(2)****Online games revenue**

The Group generates revenues from offering virtual items in online games developed by third parties or the Group itself to gaming players. Historically, the majority of online games revenues for the three years ended December 31, 2011, 2012 and 2013 were derived from third parties developed games.

Users play games through the Group's platform free of charge and are charged for purchases of virtual items including consumable and perpetual items, which can be utilized in the online games to enhance their game-playing experience. Consumable items represent virtual items that can be consumed by a specific user within a specified period of time. Perpetual items represent virtual items that are accessible to the users' account over the life of the online games.

The Group recognizes revenue when recognition criteria defined under US GAAP are satisfied. For purposes of determining when the service has been provided to the paying player, the Group has determined that an implied obligation exists to the paying player to continue providing access to the games such that the users can utilize the virtual items purchased by game tokens. Game players need to log on and access the games through the Group's platform because their game tokens, virtual items, and game history are specific to the Group's game accounts and non-transferable to other platforms. To purchase in-game virtual items, players can either charge their game accounts by purchasing game tokens or virtual currency from the Group's platform, which are convertible into game tokens based on a predetermined exchange rate agreed among the Group and the relevant game developers.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(s) Revenue recognition (Continued)****(i)****Internet value-added services (Continued)****(2)****Online games revenue (Continued)**

The proceeds from the purchase of the Group's virtual currency is recorded as "advances from customers", representing prepayments received from users in the form of the Group's virtual currency not yet converted into game specific tokens. Upon the conversion into a game token from the Group's virtual currency or upon the direct purchase of a game token, whichever is applicable, the proceeds will be shared between the Group and the relevant game developer based on a predetermined contractual ratio. Game tokens are non-refundable and non-exchangeable among different games. The Group's portion, net of the game developer's entitled consideration, is recorded as deferred revenue and amortized according to the prescribed revenue recognition policies described below. Users typically do not convert the virtual currency into game tokens or purchase the game tokens unless they plan to purchase in-game virtual items soon.

*Third party developed online games*

Pursuant to contracts signed between the Group and the respective game developers, revenues from the sale or conversion of game tokens to be used for the purchase of in-game virtual items from online games developed by third parties are shared between the Group and the game developers based on a pre-agreed ratio for each game. These revenue-sharing contracts typically last one to two years.

The third party developed games are primarily under non-exclusive licensing contracts, maintained and updated by the game developers. The Group views the game developers to be the Group's customers and considers the Group's responsibilities under the Group's agreements with the game developers to offer certain standard promotions that include providing access to the platform, announcing the new games to users on the platform, and occasional advertising on the YY platform. The determination of whether to record these revenues using gross or net method is based on an assessment of various factors. The primary factors are whether the Group is acting as the principal in offering services to the game players or as agent in the transaction, and the specific requirement of each contract. The Group determined that for third party developed games, the third party game developers are the principal given the game developers design and develop the web-game services offered, have reasonable latitude to establish prices of game tokens, and are responsible for maintaining and upgrading the game contents and virtual items. Accordingly, the Group records online games revenue, net of the pre-agreed portion of sharing of the revenues with the game developers.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(s) Revenue recognition (Continued)****(i)****Internet value-added services (Continued)****(2)****Online games revenue (Continued)**

Given that third party developed games are managed and administered by the third party game developers, the Group does not have access to the data on the consumption details such as when the game token is spent on the virtual items or the types of virtual items (consumable or perpetual items) purchased by each individual game player. However, the Group maintains historical data on timing of the conversion of its virtual currency into game specific tokens and the amount of purchases of game tokens. The Group believes that its performance for, and obligation to, the game developers correspond to the game developers' services to the users. The Group has adopted a policy to recognize revenues relating to game tokens for third party developed games over the estimated user relationship with the Group on a game-by-game basis, which are approximately one to six months for the periods presented. Future usage patterns may differ from historical usage patterns and therefore the estimated user relationship with the Group may change in the future.

When the Group launches a new game, it estimates the user relationship based on other similar types of games in the market until the new game establishes its own history. The Group considers the game's profile, attributes, target audience, and its appeal to players of different demographics groups in estimating the user relationship period.

The estimated user relationship period is based on data collected from those users who have acquired game tokens. To estimate the user relationship period, the Group maintains a software system that captures the following information for each user: (a) the frequency that users log into each game via the Group's platform, and (b) the amount and the timing of when the users convert or charge his or her game tokens. The Group estimates the user relationship period for a particular game to be the date a player purchases or converts from virtual currency to a game token through the date the Group estimates the user plays the game for the last time. This computation is completed on a user by user basis. Then, the results for all analyzed users are averaged to determine an estimated end user relationship period for each game. Revenues from in-game payments of each month are recognized over the user relationship period estimated for that game.

The consideration of user relationship with each online game is based on the Group's best estimate that takes into account all known and relevant information at the time of assessment. The Group assesses the estimated user relationships on a quarterly basis. Any adjustments arising from changes in the user relationship as a result of new information will be accounted as a change in accounting estimate in accordance with ASC 250 Accounting Changes and Error Corrections.

*Self-developed games*

Revenues derived from self-developed games are recorded on a gross basis as the Group acts as a principal to fulfill all obligations. The Group does not maintain information on consumption details of in-game virtual items, and only has limited information related to the frequency of log-ons for its self-developed games. Given that certain historical data is not available, the Group uses the user relationship of third party games with similar popularity, gaming experience and sales to determine the estimated period of user relationship for its self-developed games.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(s) Revenue recognition (Continued)****(i)****Internet value-added services (Continued)****(3)****Other IVAS revenue**

Other IVAS revenue mainly represents membership subscription revenue, revenue from sales of virtual items in various channels in YY platform, such as live game broadcasting channels etc. and other miscellaneous product sales in YY platform.

The Group operates a membership subscription program where subscription members can have enhanced user privileges when using YY Client. The membership fee is collected up-front from subscribers. The receipt of the revenue is initially recorded as deferred revenue and revenue is recognized ratably over the period of the subscription as services are rendered. Unrecognized portion beyond 12 months from balance sheet date is classified as long-term deferred revenue. Revenue from sales of virtual items in various channels is recognized on item basis, which is consistent with the revenue recognition policies in online music and entertainment revenue stream.

**(ii)****Advertising revenues**

Advertising revenues are derived principally from advertising arrangements where the advertisers pay to place their advertisements on the Group's platform in different formats over a particular period of time. Such formats generally include but are not limited to banners, text-links, videos, logos, and buttons. Advertisements on the Group's platform are generally charged on the basis of duration, and advertising contracts are signed to establish the fixed price and the advertising services to be provided. Where collectability is reasonably assured, advertising revenues from advertising contracts are recognized ratably over the contract period of display.

The Group enters into advertising contracts directly with advertisers or third party advertising agencies that represent advertisers. Contract terms generally range from 1 to 3 months. Both third party advertising agencies and direct advertisers are generally billed at the end of the display period and payments are due usually within 6 months.

Where customers purchase multiple advertising spaces with different display periods in the same contract, the Group allocates the total consideration to the various advertising elements based on the relative selling price method and recognizes revenue for the different elements over their respective display periods. The following hierarchy should be followed when determining the appropriate selling price for each element: (1) vendor specific objective evidence ("VSOE"), (2) third party evidence ("TPE"), and (3) best estimate of selling price ("BESP"). Given that the VSOE or TPE of the selling price cannot be determined, the Group has adopted a policy to allocate the fair values of different advertising elements based on the best estimate selling prices of each advertisement within the contract taking into consideration the standard price list and historical discounts granted. The Group recognizes revenue on the elements delivered and defers the recognition of revenue for the fair value of the undelivered elements until the remaining obligations have been satisfied. Where all of the elements within an arrangement are delivered uniformly over the agreement period, the revenues are recognized on a straight line basis over the contract period.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(s) Revenue recognition (Continued)**

**(ii)**

**Advertising revenues (Continued)**

*Transactions with third party advertising agencies*

For contracts entered into with third party advertising agencies, the third party advertising agencies will in turn sell the advertising services to advertisers. Revenue is recognized ratably over the contract period of display based on the following criteria:

There is persuasive evidence that an arrangement exists the Group will enter into framework and execution agreements with the advertising agencies, specifying price, advertising content, format and timing

Price is fixed or determinable price charged to the advertising agencies are specified in the agreements, including relevant discount and rebate rates

Services are rendered the Group recognizes revenue ratably as the element are delivered over the contract period of display

Collectability is reasonably assured the Group assesses credit history of each advertising agency before entering into any framework and execution agreements. If the collectability from the agencies is assessed as not reasonably assured, the Group recognizes revenue only when the cash is received and all the other revenue criteria are met.

The Group provides sales incentives in the forms of discounts and rebates to third party advertising agencies based on purchase volume. As the advertising agencies are viewed as the customers in these transactions, revenue is recognized based on the price charged to the agencies, net of sales incentives provided to the agencies. Sales incentives are estimated and recorded at the time of revenue recognition based on the contracted rebate rates and estimated sales volume based on historical experience.

*Transactions with advertisers*

The Group also enters into advertisement contracts directly with advertisers. Similar to transactions with third party advertising agencies, the Group recognizes revenue ratably as the elements are delivered over the contract period of display. The terms and conditions, including price, are fixed according to the contract between the Group and the advertisers. The Group also performs a credit assessment of all advertisers prior to entering into contracts. Revenue is recognized based on the amount charged to the advertisers, net of discounts.

**(t) Advances from customers and deferred revenue**

Advances from customers primarily consist of (i) prepayments from users in the form of the Group's virtual currency that are not yet consumed or converted into game tokens, and upon the consumption or conversion, are recognized as revenue according to the prescribed revenue recognition policies described above, (ii) prepayments from sub-licensees for obtaining operation rights of certain online games over a period of time, and (iii) prepayments from advertising agencies and advertisers.

Deferred revenue primarily consists of the unamortized game tokens, prepaid subscriptions under the membership program and unamortized revenue from virtual items in online music and entertainment channels, where there is still an implied obligation to be provided by the Group, which will be recognized as revenue when all of the revenue recognition criteria are met.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(u) Cost of revenues**

Amounts recorded as cost of revenue relate to direct expenses incurred in order to generate IVAS and advertising revenue. Such costs are recorded as incurred. Cost of revenues consists primarily of (i) revenue sharing fees and content costs, including payments to various channel owners and performers, and content providers, (ii) bandwidth costs, (iii) salary and welfare, (iv) share-based compensation, (v) business taxes and related surcharges, cultural development fee, (vi) depreciation and amortization expense for servers, other equipment and intangibles directly related to operating the platform, (vii) payment handling cost, and (viii) other costs.

In the PRC, business taxes are imposed by the government on revenues reported by any selling entity for the provision of taxable services in the PRC, transfer of intangible assets and sales of immovable properties in the PRC. The business tax rate varies depending on the nature of the revenues. The Group is also subject to cultural development fee at a tax rate of 3% on service income from provision of advertising services in the PRC.

On January 1, 2012, a pilot program (the "Pilot Program") was launched in Shanghai for a transition of imposing value-added tax ("VAT") on revenues derived from certain pilot industries (the "Pilot Industries") other than business taxes. Starting from September 1, 2012, the Pilot Program was expanded from Shanghai to eight other cities and provinces in the PRC, including Beijing and Guangdong province, where the Group's subsidiaries and VIEs are incorporated and have operations therein. The Group's advertising revenue and online games revenue are within the scope of Pilot Industries and they became subject to VAT effective from November 1, 2012 and December 1, 2012, at a rate of 6% respectively. The Group hence recognizes advertising revenue and online games revenue net of VAT thereafter. Prior to the Pilot Program's being applied to Group's revenue, the Group's advertising revenues earned from external customers were subject to business taxes at 5% for the year ended December 31, 2011, and ten months ended October 31, 2012, and the Group' IVAS revenue earned from external customers were subject to business taxes of 3% for the years ended December 31, 2011, 2012 and 2013, except that the Group's online games revenue began to be subject to VAT of 6% commencing December 2012.

The Group is subject to surcharges of business taxes and VAT, which are calculated based on 12% of the business taxes and VAT payable for the years ended December 31, 2011, 2012 and 2013.

The Group reported business taxes and surcharges, and cultural development fees incurred in cost of revenues.

Based on the Group's corporate structure and the contractual arrangements among the Group's PRC subsidiaries, the Group's VIEs and their shareholders, the Group is effectively subject to the 5% PRC business tax and generally subject to 6% VAT and related surcharges on revenues generated by the Group's subsidiaries based on the Group's contractual arrangements entered into with the Group's VIEs.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(v) Research and development expenses**

Research and development expenses consist primarily of (i) salary and welfare for research and development personnel, (ii) share-based compensation for research and development personnel, (iii) rental expenses and (iv) depreciation of office premise and servers utilized by research and development personnel. Costs incurred during the research stage are expensed as incurred. Costs incurred in the development stage, prior to the establishment of technological feasibility, which is when a working model is available, are expensed when incurred.

The Company recognizes internal use software development costs in accordance with guidance on intangible assets and internal use software. This requires capitalization of qualifying costs incurred during the software's application development stage and to expense costs as they are incurred during the preliminary project and post implementation/operation stages. The Company has not capitalized any costs related to internal use software during the years ended December 31, 2011, 2012 and 2013, respectively.

**(w) Sales and marketing expenses**

Sales and marketing expenses consist primarily of (i) salary and welfare for sales and marketing personnel, (ii) advertising and market promotion expenses, and (iii) share-based compensation for sales and marketing personnel. The advertising and market promotion expenses amounted to approximately RMB4,234, RMB5,534 and RMB8,054 during the years ended December 31, 2011, 2012 and 2013, respectively.

**(x) General and administrative expenses**

General and administrative expenses consist primarily of (i) salary and welfare for general and administrative personnel, (ii) share-based compensation for management and administrative personnel, (iii) allowance for doubtful receivables, and (iv) professional service fees.

**(y) Employee social security and welfare benefits**

Employees of the Group in the PRC are entitled to staff welfare benefits including pension, work-related injury benefits, maternity insurance, medical insurance, unemployment benefit and housing fund plans through a PRC government-mandated multi-employer defined contribution plan. The Group is required to accrue for these benefits based on certain percentages of the employees' salaries, up to a maximum amount specified by the local government. The Group is required to make contributions to the plans out of the amounts accrued. The PRC government is responsible for the medical benefits and the pension liability to be paid to these employees and the Group's obligations are limited to the amounts contributed and no legal obligation beyond the contributions made. Employee social security and welfare benefits included as expenses in the accompanying statements of operations amounted to RMB23,657, RMB39,660 and RMB68,334 for the years ended December 31, 2011, 2012 and 2013, respectively.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(z) Share-based compensation**

The Company grants stock-based award, such as, but not limited to, share options, restricted shares, restricted share units and warrants to eligible employees, officers, directors, and non-employee consultants.

Awards granted to employees, officers, and directors are initially accounted for as equity-classified awards. The related share-based compensation expenses are measured at the grant date fair value of the award and are recognized using the graded vesting method, net of estimated forfeiture rates, over the requisite service period, which is generally the vesting period. Forfeitures are estimated at the time of grant based on historical forfeiture rates and will be revised in the subsequent periods if actual forfeitures differ from those estimates. Duowan BVI also granted share options, restricted shares and restricted share units to non-employees, which are also initially accounted for as equity-classified awards. Awards granted to non-employees are initially measured at fair value on the grant date and periodically re-measured thereafter until the earlier of the performance commitment date or the date the service is completed and recognized over the period the service is provided. Awards are re-measured at each reporting date using the fair value as at each period end until the measurement date, generally when the services are completed and share-based awards are vested. Changes in fair value between the interim reporting dates are attributed consistent with the method used in recognizing the original compensation costs.

As a result of Duowan BVI's repurchases of certain awards offered in 2009 and in 2011 (Note 19), certain initially equity classified employee and non-employee awards had been reclassified as a liability classified award, as these awards were deemed to have a substantive cash settlement feature. These awards are re-measured at the end of each reporting period until either the substantive cash settlement is terminated or the holder of the awards is exposed to the market value fluctuation of the underlying shares for a reasonable period of time (at least six months), or the awards are settled, cancelled or expire unexercised.

On September 15, 2011, the board of directors of the Company resolved not to undertake any repurchases of vested or unvested share-based compensation awards, except under those conditions specified in the relevant award scheme and grant documents. In addition, any proposed repurchase of vested or unvested share-based compensation awards should be approved by the majority votes of the board of directors. Such intention of the Company was specifically communicated to all employees with or without the awards. All the employees with vested or unvested awards also confirmed such understanding by a written confirmation. Accordingly, the classification of the liability-classified awards changed back to be equity-classified.

Prior to the initial public offering date (Note 17), the Binomial option-pricing model was used to measure the fair value of all the share options. The determination of the fair value was affected by the share price as well as assumptions regarding a number of complex and subjective variables, including the expected share price volatility, actual and projected employee and non-employee share option exercise behaviour, risk-free interest rates and expected dividends. The use of the Binomial option-pricing model requires extensive actual employee, directors, officers and non-employee exercise behaviour data for the relative probability estimation purpose, and a number of complex assumptions.

Following the listing of the Company, the grant date fair value of share-based awards is based on stock price of the Company in the NASDAQ Global Market.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(aa) Other income**

Other income primarily consists of government grants which represent cash subsidies received from the PRC government by the operating subsidiaries or VIEs of the Company. Government grants are originally recorded as deferred revenue when received upfront. After all of the conditions specified in the grants have been met, the grants are recognized as operating or non-operating income based on the nature of the government grants.

**(bb) Income taxes**

Current income taxes are provided on the basis of net income for financial reporting purposes, adjusted for income and expense items which are not assessable or deductible for income tax purposes, in accordance with the regulations of the relevant tax jurisdictions. Deferred income taxes are accounted for using an asset and liability method. Under this method, deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purpose. The effect on deferred taxes of a change in tax rates is recognized in statement of operations and comprehensive (loss) income in the period of change. A valuation allowance is provided to reduce the amount of deferred tax assets if it is considered more likely than not that some portion of, or all of the deferred tax assets will not be realized.

*Uncertain tax positions*

The guidance on accounting for uncertainties in income taxes prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Guidance was also provided on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. Significant judgment is required in evaluating the Group's uncertain tax positions and determining its provision for income taxes. The Group recognizes interests and penalties, if any, under accrued expenses and other current liabilities on its balance sheet and under other expenses in its statements of operations. The Group did not recognize any significant interest and penalties associated with uncertain tax positions for the years ended December 31, 2011, 2012 and 2013. As of December 31, 2012 and 2013, the Group did not have any significant unrecognized uncertain tax positions.

**(cc) Statutory reserves**

The Group's subsidiaries, VIEs and VIE's subsidiary established in the PRC are required to make appropriations to certain non-distributable reserve funds.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(cc) Statutory reserves (Continued)**

In accordance with the laws applicable to China's Foreign Investment Enterprises, the Group's subsidiaries registered as wholly-owned foreign enterprises have to make appropriations from its after-tax profit (as determined under the Accounting Standards for Business Enterprises as promulgated by the Ministry of Finance of the People's Republic of China ("PRC GAAP")) to reserve funds including general reserve fund, and staff bonus and welfare fund. The appropriation to the general reserve fund must be at least 10% of the after-tax profits calculated in accordance with PRC GAAP. Appropriation is not required if the reserve fund has reached 50% of the registered capital of the company. Appropriation to the staff bonus and welfare fund is at the company's discretion.

In addition, in accordance with the Company Laws of the PRC, the VIEs and VIE's subsidiary of the Company registered as PRC domestic companies must make appropriations from its after-tax profit as determined under the PRC GAAP to non-distributable reserve funds including a statutory surplus fund and a discretionary surplus fund. The appropriation to the statutory surplus fund must be at least 10% of the after-tax profits as determined under the PRC GAAP. Appropriation is not required if the surplus fund has reached 50% of the registered capital of the company. Appropriation to the discretionary surplus fund is made at the discretion of the company.

The use of the general reserve fund, statutory surplus fund and discretionary surplus fund are restricted to the off-setting of losses or increasing capital of the respective company. The staff bonus and welfare fund is a liability in nature and is restricted to fund payments of special bonus to staff and for the collective welfare of employees. All these reserves are not allowed to be transferred to the company in terms of cash dividends, loans or advances, nor can they be distributed except under liquidation.

During the year ended December 31, 2013, appropriations to statutory reserves amounted to RMB40,657. No appropriations have been made in 2011 and 2012 since the companies were in accumulated loss positions.

**(dd) Related parties**

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or significant influence, such as a family member or relative, shareholder, or a related corporation.

**(ee) Dividends**

Dividends are recognized when declared. No dividends were declared for the years ended December 31, 2011, 2012 and 2013, respectively. The Group does not have any present plan to pay any dividends on common shares in the foreseeable future. The Group currently intends to retain the available funds and any future earnings to operate and expand its business.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**2. Principal accounting policies (Continued)**

**(ff) (Loss) income per share**

Basic (loss) income per share is computed by dividing net (loss) income attributable to common shareholders, considering the accretion or decreration of redemption feature, deemed dividend to preferred shareholders and amortization of beneficial conversion feature related to its convertible redeemable preferred shares (Note 20), by the weighted average number of common shares outstanding during the period using the two-class method. Under the two-class method, net income is allocated between common shares and other participating securities based on their participating rights. Net losses are not allocated to other participating securities if based on their contractual terms they are not obligated to share the losses.

Diluted (loss) income per share is calculated by dividing net (loss) income attributable to common shareholders, as adjusted for the effect of dilutive common equivalent shares, if any, by the weighted average number of common and dilutive common equivalent shares outstanding during the period. Common equivalent shares consist of common shares issuable upon the conversion of the preferred shares, using the if-converted method, and shares issuable upon the exercise of share options using the treasury stock method. Common equivalent shares are not included in the denominator of the diluted loss per share calculation when inclusion of such share would be anti-dilutive.

**(gg) Comprehensive (loss) income**

Comprehensive (loss) income is defined as the change in equity of the Company during a period arising from transactions and other events and circumstances excluding transactions resulting from investments by shareholders and distributions to shareholders. Comprehensive (loss) income is reported in the consolidated statements of operations and comprehensive (loss) income. Accumulated other comprehensive loss of the Group includes the foreign currency translation adjustments.

**(hh) Segment reporting**

Operating segments are defined as components of an enterprise engaging in businesses activities for which separate financial information is available that is regularly evaluated by the Group's chief operating decision makers in deciding how to allocate resources and assess performance. The Group's chief operating decision maker has been identified as the Chief Executive Officer, who reviews consolidated results when making decisions about allocating resources and assessing performance of the Group. The Group has internal reporting of cost and expenses that does not distinguish between segments, and reports costs and expenses by nature as a whole. The Group does not distinguish between markets or segments for the purpose of internal reporting. Hence, the Group has only one operating segment. As the Group's long-lived assets and revenue are substantially located in and derived from the PRC, no geographical segments are presented.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(ii) Recently issued accounting pronouncements**

In February of 2013, the FASB issued ASU 2013-02, "*Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*". The amendments in this ASU require an entity to provide information about amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income (for example, where amounts are reclassified to inventory), an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. For public entities, the amendments are effective with prospective application for reporting periods beginning after December 15, 2012. The Group adopted this ASU beginning January 1, 2013 and the adoption of this ASU did not have a material impact on the Group's consolidated financial statements.

In March of 2013, the FASB issued ASU 2013-05, "*Foreign Currency Matters (Topic 830), Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity*." The amendments in this ASU clarify the applicable guidance for the de-recognition of all or a portion of a cumulative translation adjustment when an entity ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity or when other changes stipulated in the ASU occur and involve a foreign entity. The amendments are effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. The amendments should be applied prospectively to derecognition events occurring after the effective date. Prior periods should not be adjusted. Early adoption is permitted. If an entity elects to early adopt the amendments, it should apply them as of the beginning of the entity's fiscal year of adoption. The adoption of this ASU is not reasonably expected in the future to have a material impact on the Group's consolidated financial statements.

In March of 2013, the FASB issued ASU 2013-11, "*Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*". The amendments in the ASU clarify that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss, similar tax loss, or tax credit carryforward, except as noted in the following sentence. To the extent a net operating loss, similar tax loss, or tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such a purpose, then under this exception the unrecognized tax benefit is to be presented in the financial statements as a liability and should not be combined with (netted with) the deferred tax asset(s). The assessment of whether a deferred tax asset is "available" is based on the unrecognized tax benefit and deferred tax asset amounts that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****2. Principal accounting policies (Continued)****(ii) Recently issued accounting pronouncements (Continued)**

adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of this ASU is not reasonably expected in the future to have a material impact on the Group's consolidated financial statements.

**3. Certain risks and concentration****(a) PRC regulations**

Foreign ownership of internet-based businesses is subject to significant restrictions under the current PRC laws and regulations. The PRC government regulates internet access, the distribution of online information and the conduct of online commerce through strict business licensing requirements and other government regulations. These laws and regulations also limit foreign ownership in PRC companies that provide internet information distribution services. Specifically, foreign ownership in an internet information provider or other value-added telecommunication service providers may not exceed 50%. Foreigners or foreign invested enterprises are currently not able to apply for the required licenses for operating online games in the PRC. The Company is incorporated in the Cayman Islands and accordingly, the Company is considered as a foreign invested enterprise under PRC law.

In order to comply with the PRC laws restricting foreign ownership in the online business in China, the Group operates the online business in China through contractual arrangements with Guangzhou Huaduo and Beijing Tuda, the Group's two VIEs. As of December 31, 2013, Mr. David Xueling Li, CEO, Mr. Jun Lei, Chairman of the Company, Mr. Tony Bin Zhao, Director and Chairman of Technology Committee, Mr. Jin Cao, General Manager of the Website Department, and Beijing Tuda own approximately 0.5%, 0.44%, 0.04%, 0.02% and 99% of Guangzhou Huaduo's equity interests, respectively. As of December 31, 2013, Mr. David Xueling Li, Mr. Tony Bin Zhao, and Mr. Jin Cao, own 97.7%, 1.5% and 0.8% of Beijing Tuda's equity interests, respectively.

The VIEs hold the licenses and permits necessary to conduct its internet value-added services and online advertising business in the PRC. If the Company had direct ownership of the VIEs, it would be able to exercise its rights as a shareholder to effect changes in the board of directors, which in turn could affect changes at the management level, subject to any applicable fiduciary obligations. However, under the current contractual arrangements, it relies on the VIEs and its' shareholders' performance of their contractual obligations to exercise effective control. In addition, the Group's contractual agreements have terms range from 10 to 30 years, which are subject to Beijing Huanju Shidai's unilateral termination right. Under the respective service agreements, Beijing Huanju Shidai will provide services including technology support, technology services, business support and consulting services to Beijing Tuda and Guangzhou Huaduo in exchange for service fees. The amount of service fees payable is determined by various factors, including (a) a percentage of Beijing Tuda and Guangzhou Huaduo's revenues or earnings, and (b) the expenses that Beijing Huanju Shidai incurs for providing such services. Beijing Huanju Shidai may charge up to 100% of the income in Beijing Tuda and Guangzhou Huaduo and a multiple of the expenses incurred for providing such services, as determined by Beijing Huanju Shidai from time to time. The service fees payable by Beijing Tuda and Guangzhou Huaduo to Beijing Huanju Shidai are determined to be up to 100% of the profits of the Beijing Tuda and Guangzhou Huaduo, with the timing of such payment to be determined at the sole discretion of Beijing Huanju Shidai. If fees were incurred, it would be significant to the Company and

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**3. Certain risks and concentration (Continued)**

**(a) PRC regulations (Continued)**

the operating companies' economic performance because it will be incurred and paid at up to 100% of the earnings of the VIEs. Fees incurred would be remitted, subject to further PRC restrictions. None of the VIEs or their shareholders are entitled to terminate the contracts prior to the expiration date, unless under remote circumstances such as a material breach of agreement or bankruptcy as it pertains to the service and business operation agreements and their amendment. For the years ended December 31, 2011 and 2012, no service fees were charged by WOFEs to VIEs as both VIEs had accumulated losses since inception. For the year ended December 31, 2013, Beijing Huanju Shidai determined that service fees of RMB31,153 were charged to Guangzhou Huaduo considering it achieved accumulated profitability during the year ended December 31, 2013. The service fees are typically determined based on the costs and expenses that WOFEs incurs for providing relevant technology support to Guangzhou Huaduo, as well as the consideration of Guangzhou Huaduo's future business development plan and its increasingly growing and diverse operational needs.

Further, the Group believes that the contractual arrangements among Beijing Huanju Shidai, the VIEs, and their shareholders are in compliance with PRC law and are legally enforceable. However, the PRC government may issue from time to time new laws or new interpretations on existing laws to regulate this industry. Regulatory risk also encompasses the interpretation by the tax authorities of current tax laws, and the Group's legal structure and scope of operations in the PRC, which could be subject to further restrictions resulting in limitations on the Company's ability to conduct business in the PRC. The PRC government may also require the Company to restructure the Group's operations entirely if it finds that its contractual arrangements do not comply with applicable laws and regulations. Furthermore, it could revoke the Group's business and operating licenses, require it to discontinue or restrict its operations, restrict its right to collect revenues, block its website, require it to restructure its operations, impose additional conditions or requirements with which the Group may not be able to comply, or take other regulatory or enforcement actions against the Group that could be harmful to its business. The imposition of any of these penalties may result in a material and adverse effect on the Group's ability to conduct the Group's business. In addition, if the imposition of any of these penalties causes the Group to lose the rights to direct the activities of the VIEs or the right to receive their economic benefits, the Group would no longer be able to consolidate the VIEs. The Group does not believe that any penalties imposed or actions taken by the PRC government would result in the liquidation of the Company, Beijing Huanju Shidai, and the VIEs.



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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(All amount in thousands, except share and per share data, unless otherwise stated)

## 3. Certain risks and concentration (Continued)

## (a) PRC regulations (Continued)

The following consolidated financial information of the Group's VIEs and VIE's subsidiary excluding the intercompany items with the Group's subsidiaries was included in the accompanying consolidated financial statements as of and for the years ended:

	December 31,	
	2012	2013
	RMB	RMB
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	204,606	575,262
Short-term deposits	90,000	594,000
Accounts receivable, net	41,824	48,329
Amount due from a related party	1,073	73
Prepayments and other current assets	14,897	29,753
Deferred tax assets	25,666	51,631
<b>Total current assets</b>	<b>378,066</b>	<b>1,299,048</b>
<b>Non-current assets</b>		
Deferred tax assets	92	383
Investments	2,950	33,920
Property and equipment, net	88,709	100,059
Intangible assets, net	3,218	9,717
<b>Total non-current assets</b>	<b>94,969</b>	<b>144,079</b>
<b>Total assets</b>	<b>473,035</b>	<b>1,443,127</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable	27,124	55,818
Deferred revenue	158,323	292,380
Advances from customers	7,271	10,656
Income taxes payable	32,885	47,974
Accrued liabilities and other current liabilities	81,223	197,851
Amounts due to related parties	2,604	2,640
<b>Total current liabilities</b>	<b>309,430</b>	<b>607,319</b>

**Non-current liabilities**

Deferred revenue	4,525	8,457
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<b>Total liabilities</b>	313,955	615,776
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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**3. Certain risks and concentration (Continued)****(a) PRC regulations (Continued)**

	For the year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Net revenues	232,376	702,929	1,669,852
Net (loss) income	(79,334)	80,071	486,095

  

	For the year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Net cash provided by operating activities	57,313	322,378	845,198
Net cash used in investing activities	(46,475)	(152,197)	(592,390)
	10,838	170,181	252,808

**(b) Foreign exchange risk**

The revenues and expenses of the Group's subsidiaries, VIEs and VIE's subsidiary in the PRC are generally denominated in RMB and their assets and liabilities are denominated in RMB. The Group's financing activities are denominated in U.S. dollars. The RMB is not freely convertible into foreign currencies. Remittances of foreign currencies into the PRC and exchange of foreign currencies into RMB require approval by foreign exchange administrative authorities and certain supporting documentation. The State Administration for Foreign Exchange, under the authority of the People's Bank of China, controls the conversion of RMB into other currencies.

**(c) Concentration of risks**

(i)

**Concentration of revenue**

No individual customer accounted for more than 10% of net revenues for the years ended December 31, 2011, 2012 and 2013.

(ii)

**Concentration of accounts receivable**

The Group collects accounts receivable for IVAS revenue from collection agencies and accounts receivable for online advertising revenue from customers. The Group depends on payments from a limited number of the collection agencies and customers. The top 10 accounts receivable accounted for 96%, 92% and 87% of the total accounts receivable as of December 31, 2011, 2012 and 2013, respectively.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**3. Certain risks and concentration (Continued)****(c) Concentration of risks (Continued)****(ii)****Concentration of accounts receivable (Continued)**

The following table summarizes the percentage of accounts receivable from collection agencies and customers with over 10% of total accounts receivable:

	For the year ended December 31,		
	2011 RMB	2012 RMB	2013 RMB
Collection agencies and customers			
B1	31%	34%	25%
B2	*	*	12%
B3	*	16%	11%
B4	12%	*	*
B5	12%	*	*

\*

Less than 10%

**(d) Credit risk**

As of December 31, 2012 and 2013, substantially all of the Group's cash and cash equivalents and short-term deposits were held by the PRC and international financial institutions. Management chooses these institutions because of their reputations and track records for stability, and their known large cash reserves, and management periodically reviews these institutions' reputations, track records, and reported reserves. Management expects that any additional institutions that the Group uses for its cash and bank deposits will be chosen with similar criteria for soundness. The balances in the PRC are not insured since it is not a market practice in the PRC. Nevertheless under the PRC law, it is required that a commercial bank in the PRC that holds third party cash deposits should maintain a certain percentage of total customer deposits taken in a statutory reserve fund for protecting the depositors' rights over their interests in deposited money. PRC banks are subject to a series of risk control regulatory standards; PRC bank regulatory authorities are empowered to take over the operation and management of any PRC bank that faces a material credit crisis. The Group believes that it is not exposed to unusual risks as these financial institutions are either PRC banks or international banks that carry at least 'A' credit ratings from one or more credit rating agencies. The Group had not experienced any losses on its deposits of cash and cash equivalents and term deposits during the years ended December 31, 2011, 2012 and 2013 and believes that its credit risk to be minimal.

[Table of Contents](#)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****4. Business combination**

On March 12, 2012, the Group acquired a majority of the assets of an internet service company, which is in the business of operating an internet platform, for cash consideration of RMB11,722. As a result of the acquisition, the Group obtained the key intellectual property to develop and expand the platform of YY Client. The acquisition was recorded using the acquisition method of accounting and the allocation of the purchase price at the date of acquisition is as follows:

	<b>RMB</b>
Property and equipment	128
Intangible assets	
Technology	10,035
Software	660
Goodwill	899
Total	11,722

The business combination was completed on March 12, 2012 and there was no further adjustment to the purchase price allocation. The excess of purchase price over tangible assets and identifiable intangible assets acquired and liabilities assumed was recorded as goodwill. The acquired goodwill is not deductible for tax purposes. Acquisition related costs were immaterial and were included in general and administrative expenses for the year ended December 31, 2012.

Pro forma results of operations related to the acquisition have not been presented because they are not material to the Group's consolidated statements of operations and comprehensive (loss) income for the years ended December 31, 2011, 2012 and 2013.

Since the acquired business has been fully integrated into the Company's current business after the acquisition, it is impracticable to disclose separately its standalone revenue and earnings after the acquisition.

**5. Cash and cash equivalents**

Cash and cash equivalents represent cash on hand and demand deposits placed with banks or other financial institutions. Cash and cash equivalents balance as of December 31, 2012 and 2013 primarily consist of the following currencies:

	<b>December 31, 2012</b>		<b>December 31, 2013</b>	
	<b>Amount</b>	<b>RMB equivalent</b>	<b>Amount</b>	<b>RMB equivalent</b>
RMB	460,176	460,176	715,316	715,316
US\$	7,084	44,526	2,342	14,282
Total		504,702		729,598

**6. Short-term deposits**

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Short-term deposits represent time deposits placed with banks with original maturities of less than one year. Short-term deposits balance as of December 31, 2012 and 2013 were all denominated in RMB.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**7. Accounts receivable, net**

	December 31,	
	2012	2013
	RMB	RMB
Accounts receivable, gross	123,332	131,315
Less: allowance for doubtful receivables	(5,716)	(31,214)
<b>Accounts receivable, net</b>	<b>117,616</b>	<b>100,101</b>

The following table summarized the details of the Company's allowance for doubtful accounts:

	For the year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Balance at the beginning of the year	(387)		(5,716)
Additions charged to general and administrative expenses		(6,884)	(31,987)
Write-off during the year	387	1,168	6,489
<b>Balance at the end of the year</b>		<b>(5,716)</b>	<b>(31,214)</b>

**8. Investments**

	December 31	
	2012	2013
	RMB	RMB
Cost investments (i)(ii)		47,110
Equity investments	2,950	14,919
<b>Total</b>	<b>2,950</b>	<b>62,029</b>

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(i)

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In June 2013, the Company made an investment with an equity interest of 20% in a company with consideration of RMB15 million. The investment was not an investment in common stock or in-substance common stock and therefore was precluded from applying the equity method of accounting. It has been accounted for as an investment under cost method.

(ii)

In December 2013, the Company entered into agreements to acquire a minority stake of preferred shares of two companies with total consideration of approximately RMB28 million. Given the fact that the Company cannot unilaterally demand redemption of both the two preferred stocks as the Company only owns less than or equal to 10% of the two preferred stocks respectively, these investments have been accounted for as an investment in an equity security under cost method since the two equity securities do not have a readily determinable fair value.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**9. Property and equipment, net**

Property and equipment consists of the following:

	December 31,	
	2012 RMB	2013 RMB
<b>Gross carrying amount</b>		
Servers, computers and equipment	103,005	152,404
Leasehold improvement	22,831	23,257
Furniture, fixture and office equipment	9,083	9,672
Motor vehicles	2,999	5,186
Construction in progress		4,652
<b>Total</b>	<b>137,918</b>	<b>195,171</b>
<b>Less: accumulated depreciation</b>	<b>(47,619)</b>	<b>(92,535)</b>
<b>Property and equipment, net</b>	<b>90,299</b>	<b>102,636</b>

Depreciation expense for the years ended December 31, 2011, 2012 and 2013 were RMB12,888, RMB29,074 and RMB44,963, respectively.

**10. Intangible assets, net**

The following table summarizes the Group's intangible assets:

	December 31	
	2012 RMB	2013 RMB
<b>Gross carrying amount</b>		
Software	4,235	5,477
Technology	9,962	17,121
Domain name	11,477	17,286
<b>Total of gross carrying amount</b>	<b>25,674</b>	<b>39,884</b>
<b>Less: accumulated amortization</b>		
Software	(1,808)	(3,209)
Technology	(1,659)	(4,054)
Domain name	(2,176)	(2,944)

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Total accumulated amortization	(5,643)	(10,207)
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**Less: impairment**

Software	(550)	(550)
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<b>Intangible assets, net</b>	<b>19,481</b>	<b>29,127</b>
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Amortization expense for the years ended December 31, 2011, 2012 and 2013 were RMB1,211, RMB3,369 and RMB4,707, respectively.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****10. Intangible assets, net (Continued)**

The estimated amortization expenses for each of the following five years are as follows:

	Domain name	Technology	Software
	RMB	RMB	RMB
2014	1,171	3,424	1,263
2015	1,149	3,424	335
2016	1,141	3,424	68
2017	1,141	1,806	33
2018	1,141	989	19

The weighted average amortization periods of intangible assets as of December 31, 2012 and 2013 are as below:

	December 31,	
	2012	2013
Domain name	15 years	15 years
Technology	5 years	5 years
Software	3 years	3 years

**11. Goodwill**

Goodwill of RMB1,577 represents the excess of the purchase price over the estimated fair value of the net tangible and identifiable intangible assets acquired. Goodwill is not deductible for tax purposes. The Group performs the annual impairment tests on October 1 of each year. Based on the impairment tests performed, no impairment of goodwill was recorded for all periods presented.

**12. Deferred revenue**

	December 31,	
	2012	2013
	RMB	RMB
<b>Deferred revenue, current:</b>		
IVAS revenues	157,940	292,184
Government grants	1,919	1,682

Total current deferred revenue	159,859	293,866
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<b>Deferred revenue, non-current:</b>		
IVAS revenues	4,329	8,457
Government grants	2,158	968

Total non-current deferred revenue	6,487	9,425
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[Table of Contents](#)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****13. Accrued liabilities and other current liabilities**

	<b>December 31,</b>	
	<b>2012</b>	<b>2013</b>
Accrued salaries and welfare	54,688	113,302
Accrued revenue sharing fees	19,504	66,512
Accrued bandwidth costs	15,679	21,869
Business and other taxes payable	7,422	14,248
Value added taxes payable	8,718	5,291
Accrued technology service fee	2,162	5,040
Others	12,116	24,498
<b>Total</b>	<b>120,289</b>	<b>250,760</b>

**14. Cost of revenue**

	<b>For the year ended December 31,</b>		
	<b>2011</b>	<b>2012</b>	<b>2013</b>
	<b>RMB</b>	<b>RMB</b>	<b>RMB</b>
Revenue sharing fees and content costs	6,750	109,273	444,065
Bandwidth costs	75,064	145,037	203,238
Salary and welfare	33,388	50,009	88,456
Business tax and surcharges	16,462	30,026	47,755
Depreciation and amortization	11,951	25,762	37,084
Payment handling costs	9,306	22,828	24,955
Shared-based compensation	15,449	8,407	9,860
Other costs	14,329	24,791	26,586
<b>Total</b>	<b>182,699</b>	<b>416,133</b>	<b>881,999</b>

**15. Other income**

	<b>For the year ended December 31,</b>		
	<b>2011</b>	<b>2012</b>	<b>2013</b>
	<b>RMB</b>	<b>RMB</b>	<b>RMB</b>
Government grants	1,982	2,465	25,356
Others			1,722
<b>Total</b>	<b>1,982</b>	<b>2,465</b>	<b>27,078</b>

**16. Income tax**

**(i) Cayman Islands ("Cayman")**

Under the current tax laws of Cayman Islands, the Company and its subsidiaries are not subject to tax on income or capital gains. Besides, upon payment of dividends by the Company to its shareholders, no Cayman Islands withholding tax will be imposed.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**16. Income tax (Continued)**

**(ii) British Virgin Islands ("BVI")**

Duowan BVI is exempt from income tax on its foreign-derived income in the BVI. There are no withholding taxes in the BVI.

**(iii) Hong Kong profits tax**

Entities incorporated in Hong Kong are subject to Hong Kong profits tax at a rate of 16.5% on the estimated assessable profit for the years ended December 31, 2011, 2012 and 2013.

**(iv) PRC Enterprise Income Tax ("EIT")**

The Company's subsidiaries, VIEs and VIE's subsidiary in China are governed by the Enterprise Income Tax Law ("EIT Law"), which became effective on January 1, 2008. Pursuant to the EIT Law and its implementation rules, enterprises in China are generally subjected to tax at a statutory rate of 25%. Certified High and New Technology Enterprises ("HNTE") are entitled to a favorable statutory tax rate of 15%, and qualified software enterprises can enjoy an income tax exemption for two years beginning with their first profitable year and a 50% tax reduction to the applicable tax rate for the subsequent three years.

The Group's PRC entities accrued for enterprise income tax as follows:

From 2011 to 2013, Guangzhou Huaduo accrued the EIT at a tax rate of 15% as a result of HNTE status.

Guangzhou Huanju Shidai reported tax loss from 2010 to 2013. On December 31, 2013, Guangzhou Huanju Shidai was granted the qualification as software enterprise and will enjoy the preferential tax beginning from its first profitable year.

Other PRC subsidiaries, VIE and VIE's subsidiary were subject to 25% EIT for the periods reported.

According to a policy promulgated by the State Tax Bureau of the PRC and effective from 2008 onwards, enterprises engage in research and development activities are entitled to claim 150% of the research and development expenses so incurred in a year as tax deductible expenses in determining its tax assessable profits for that year ("Super Deduction"). Certain subsidiaries and VIEs of the Group successfully claimed the Super Deduction in ascertaining the tax assessable profits for the periods reported.

In addition, according to the New EIT Law and its implementation rules, foreign enterprises, which have no establishment or place in the PRC but derive dividends, interest, rents, royalties and other income (including capital gains) from sources in the PRC shall be subject to PRC withholding tax ("WHT") at 10% (a further reduced WHT rate may be available according to the applicable double tax treaty or arrangement). The 10% WHT is applicable to any dividends to be distributed from the Group's PRC subsidiaries, VIEs and VIE's subsidiaries to the Group's oversea companies.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****16. Income tax (Continued)****(iv) PRC Enterprise Income Tax ("EIT") (Continued)**

Aggregate undistributed earnings of the Company's subsidiaries located in the PRC that are available for distribution to the Company as of December 31, 2012 and 2013 are approximately RMB204,960 and RMB753,975, respectively. The undistributed earnings of the Company's subsidiaries, VIEs and VIE's subsidiary located in the PRC are considered to be indefinitely reinvested, because the Group does not have any present plan to pay any cash dividends on its common shares in the foreseeable future and intends to retain most of its available funds and any future earnings for use in the operation and expansion of its business. Accordingly, no deferred tax liability has been accrued for the Chinese dividend withholding taxes that would be payable upon the distribution of those amounts to the Company as of December 31, 2012 and 2013.

*Composition of income tax expense*

The current and deferred portions of income tax expense included in the consolidated statements of operations are as follows:

	<b>For the year ended December 31,</b>		
	<b>2011</b>	<b>2012</b>	<b>2013</b>
	<b>RMB</b>	<b>RMB</b>	<b>RMB</b>
Current income tax expenses	(12,516)	(48,357)	(125,365)
Deferred income tax benefits	11,173	19,316	35,414
<b>Income tax expense for the year</b>	<b>(1,343)</b>	<b>(29,041)</b>	<b>(89,951)</b>

*Reconciliation of the differences between statutory tax rate and the effective tax rate*

The reconciliation of total tax expense computed by applying the respective statutory income tax rate to pre-tax (loss) income is as follows:

	<b>For the year ended December 31,</b>		
	<b>2011</b>	<b>2012</b>	<b>2013</b>
	<b>RMB</b>	<b>RMB</b>	<b>RMB</b>
PRC Statutory income tax rate	(25.0%)	(25.0%)	(25.0%)
Effect of preferential tax rate	8.4%	10.4%	10.5%
Effect of tax-exempt entities	(5.1%)	0.2%	2.2%
Permanent differences <sup>(i)</sup>	32.5%	(13.9%)	(4.0%)
Change in valuation allowance	(7.8%)	(2.0%)	(3.0%)
Effect of Super Deduction available to the Group	(4.9%)	5.7%	3.4%
Adjustments of deferred tax for changes in tax rates	3.6%		
<b>Effective income tax rate</b>	<b>1.7%</b>	<b>(24.6%)</b>	<b>(15.9%)</b>



- (i) Permanent differences mainly arise from expenses not deductible for tax purposes including primarily share-based compensation costs and expenses incurred by subsidiaries and VIEs.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****16. Income tax (Continued)***Deferred tax assets and liabilities*

Deferred taxes were measured using the enacted tax rates for the periods in which they are expected to be reversed. The tax effects of temporary differences that give rise to the deferred tax asset balances as of December 31, 2012 and 2013 are as follows:

	<b>December 31,</b>	
	<b>2012</b>	<b>2013</b>
	<b>RMB</b>	<b>RMB</b>
<b>Deferred tax assets, current:</b>		
Deferred revenue	16,270	32,905
Allowance for doubtful accounts receivable, accrued expense and others not currently deductible for tax purposes	17,062	39,791
Valuation allowance <sup>(i)</sup>	(1,783)	(5,775)
<b>Total current deferred tax assets, net</b>	<b>31,549</b>	<b>66,921</b>
<b>Deferred tax assets, non-current:</b>		
Tax loss carried forward	2,433	16,400
Deferred revenue	538	445
Impairment of an equity investment	45	180
Valuation allowance <sup>(i)</sup>	(2,433)	(16,400)
<b>Total non-current deferred tax assets, net</b>	<b>583</b>	<b>625</b>

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- (i) Valuation allowance is provided against deferred tax assets when the Group determines that it is more likely than not that the deferred tax assets will not be utilized in the future. In making such determination, the Group considered factors including future taxable income exclusive of reversing temporary differences and carry forwards. Valuation allowance was provided for net operating loss carry forward because it was more likely than not that such deferred tax assets will not be realized based on the Group's estimate of its future taxable income. If events occur in the future that allow the Group to realize more of its deferred income tax than the presently recorded amounts, an adjustment to the valuation allowances will result in a decrease in tax expense when those events occur.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****16. Income tax (Continued)***Tax loss carry forwards*

As of December 31, 2013, the Group had tax loss carry forwards of approximately RMB62,994, which can be carried forward to offset future taxable income. The net operating tax loss carry forwards will begin to expire as follows:

	<b>Amount</b>
	<b>RMB</b>
2014	3,184
2015	
2016	3,405
2017	3,034
2018	53,371
Total	62,994

In accordance with PRC Tax Administration Law on the Levying and Collection of Taxes, the PRC tax authorities generally have up to five years to claw back underpaid tax plus penalties and interest for PRC entities' tax filings. In the case of tax evasion, which is not clearly defined in the law, there is no limitation on the tax years open for investigation. Accordingly, the PRC entities' tax years from 2009 to 2013 remain subject to examination by the tax authorities. There were no ongoing examinations by tax authorities as of December 31, 2013.

**17. Common shares***Common Shares*

In January 2011, Duowan BVI entered into a common share and warrant purchase agreement with an independent institutional investor with respect to the issuance and sale of 51,140,432 common shares at an aggregate consideration of US\$50,000 and a warrant to purchase up to an additional 25,570,216 common shares for an aggregate purchase price of US\$25,000 ("Series D Common Share Financing"). The issuance price of each common share is US\$0.9777, of which US\$0.0830 per share relates to the fair value of the warrant. The related issuance costs were RMB1,208. In July 2011, the institutional investor exercised the warrant to acquire 25,570,216 common shares of Duowan BVI.

On October 31, 2012, several executives of the Company converted in aggregate 5,068,000 vested restricted shares into common shares.

Upon the completion of the Company's IPO on November 21, 2012 (Note 1(c)), the Company's shares were divided into Class A common shares and Class B common shares, par value of US\$0.00001. Holders of Class A common shares and Class B common shares have the same rights, except for voting rights and conversion rights. Holders of Class A common shares are entitled to one vote per share in all shareholders' meetings, while holders of Class B common shares are entitled to ten votes per share. Each Class B common share is convertible into one Class A common share at any time at the discretion of the Class B shareholders thereof, while Class A common shares are not convertible into Class B common shares under any circumstances. The impact of dividing Class A and Class B common shares has been retroactively reflected in the Company's capital structure in the consolidated financial statements.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**17. Common shares (Continued)**

As of December 31, 2011, nil Class A common shares and 4,640,575,690 Class B common shares had been authorized, nil Class A common shares and 543,340,914 Class B common shares had been issued and outstanding.

As of December 31, 2012, 10,000,000,000 Class A common shares and 1,000,000,000 Class B common shares had been authorized, 179,400,000 Class A common shares and 907,833,224 Class B common shares had been issued and outstanding, respectively.

During the year ended December 31, 2013, 21,256,900 Class A common shares were issued for the exercised share options, vested restricted shares and restricted share units, 422,001,838 Class B common shares were converted to Class A common shares.

As of December 31, 2013, 10,000,000,000 Class A common shares and 1,000,000,000 Class B common shares had been authorized, 622,658,738 Class A common shares and 485,831,386 Class B common shares had been issued and outstanding, respectively.

**18. Convertible redeemable preferred shares**

During the First Reorganization, Duowan Limited issued 54,488,000 Series A convertible preferred shares ("Series A Preferred Shares") and warrant to a third party investor ("Series A Investor") in exchange for an aggregate purchase price of RMB7,720, or US\$0.0184 per share. During the Second Reorganization in June 2008, Duowan BVI issued an additional 81,612,930 Series A convertible preferred shares to the Series A Investor for an aggregate purchase price of RMB13,722. The related issuance costs were RMB172.

In August 2008, Duowan BVI issued 102,073,860 Series B convertible redeemable preferred shares ("Series B Preferred Shares") for aggregate cash consideration of RMB34,232 and issuance costs of RMB278.

In November 2009, Duowan BVI issued 16,249,870 Series C-1 convertible redeemable preferred shares ("Series C-1 Preferred Shares") and 104,999,650 C-2 convertible redeemable preferred shares ("Series C-2 Preferred Shares", collectively with Series C-1 Preferred Shares, "Series C Preferred Shares"), for aggregate cash considerations of RMB8,875 and RMB71,684 respectively. Series C Preferred Shares issuance costs were RMB274.

Series A Preferred Shares, Series B Preferred Shares and Series C Preferred Shares are collectively referred to as the "Preferred Shares".

As of December 31, 2011, the Company has determined that the Preferred Shares should be classified as mezzanine equity since the Preferred Shares are contingently redeemable by the holders in the event that a qualified IPO has not occurred and the Preferred Shares have not been converted as of the redemption date.

The Company determined that there were no embedded derivatives requiring bifurcation as the economic characteristics and risks of the conversion feature embedded in derivative instrument are clearly and closely related to that of the convertible preferred shares, and the convertible and redeemable preferred shares are not readily convertible into cash as there is no market mechanism in place for trading its share.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**18. Convertible redeemable preferred shares (Continued)**

As of December 31, 2011, the Preferred Shares comprised of the following:

Series	Issuance Date	Shares Issued and Outstanding	Issue Price Per Share (US\$)	Proceeds from Issuance, Net of Issuance Costs (US\$)	Carrying Amount (RMB)
A	December 1, 2006	54,488,000	0.0184	1,000	374,332
A	June 2, 2008	81,612,930	0.0245	1,975	560,681
B	August 8, 2008	102,073,860	0.0490	4,959	703,901
C-1	November 22, 2009	16,249,870	0.0800	1,300	112,556
C-2	November 22, 2009	104,999,650	0.1000	10,460	729,464

All Preferred Shares' par value is US\$0.00001. The rights, preferences and privileges of the Preferred Shares are as follows:

***Conversion***

Each Preferred Share was convertible, at the option of the holders, at any time after the date of issuance of such preferred shares into such number of common shares according to a conversion price. Each share of Series A, Series B, Series C Preferred Shares was convertible into one common share and was subject to adjustments for certain events, including but not limited to additional equity securities issuance, share dividends, subdivisions, redemptions, combinations, or consolidation of common shares. The conversion price is also subject to adjustment in the event the Company issues additional common shares at a price per share that is less than such conversion price. In such case, the conversion price shall be reduced to adjust for dilution.

Each Preferred Share was automatically converted into common shares at the then effective conversion price with respect to such Preferred Share (i) at the closing of a Qualified IPO, or (ii) at the election of the majority Series A, Series B, and Series C Preferred Shares holders (each voting or consenting as a separate class).

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****18. Convertible redeemable preferred shares (Continued)*****Conversion (Continued)***

As of December 31, 2010, the Qualified IPO is defined as a firm-commitment public offering of common shares of the Company in the United States that has been registered under the Securities Act and on a recognized securities exchange such as NASDAQ or the New York Stock Exchange, or in a similar public offering of common shares in a jurisdiction and on a recognized securities exchange outside of the United States, including without limitation, the Hong Kong Stock Exchange, provided that (a) the market capitalization of the Company upon completion of such initial public offering shall be no less than US\$400,000 and such public offering and the aggregate proceeds (before deduction of underwriting discounts and registration expenses) is approved by majority of the board of directors (including the affirmative consent of the majority of the Series A, Series B, and Series C Preferred Shares director), or (b) such public offering and the aggregate proceeds (before deduction of underwriting discounts and registration expenses) is approved by majority of the board of directors (including the affirmative consent of each of the Preferred Shares' directors), and provided further that such public offering is made at an equivalent price and yields equivalent offering proceeds and there is regulatory approval for such offering. Subsequent to the Series D Common Share Financing in January 2011, the Qualified IPO is defined as a firm-commitment public offering of common shares of the Company in the United States that has been registered under the Securities Act and on a recognized securities exchange such as NASDAQ or the New York Stock Exchange, or in a similar public offering of common shares in a jurisdiction and on a recognized securities exchange outside of the United States, including without limitation, the Hong Kong Stock Exchange, provided that (a) the market capitalization of the Company upon completion of such initial public offering shall be no less than US\$1,500,000 and such public offering and the aggregate proceeds (before deduction of underwriting discounts and registration expenses) is approved by majority of the Board of Directors (including the affirmative consent of the majority of the Series A Director, the Series B Director, the Series C Director and the Series D director), or (b) such public offering and the aggregate proceeds (before deduction of underwriting discounts and registration expenses) is approved by majority of the Board of Directors (including the affirmative consent of each of the Series A Director, the Series B Director, the Series C Director and the Series D Director, if applicable), and provided further that such public offering is made at an equivalent price and yields equivalent offering proceeds and there is regulatory approval for such offering.

On September 19, 2012, the board of directors of the Company resolved to approve to raise additional capital through an underwritten initial public offering of its shares in the United States of America as a Qualified IPO.

Upon the completion of the IPO on November 21, 2012, each Preferred Share was automatically converted into one Class B common share. As a result, 359,424,310 Class B common shares were issued, and the balance of Preferred Shares was transferred to Class B common shares and additional paid-in capital on the same day.

***Redemption Right***

As of December 31, 2010, at any time after the date that is the earlier of i) the date of the occurrence of a Default Redemption Event, and ii) five years following the Series C-1 original issue date and Series C-2 original issue date, at the election of the majority of Series C holders, the Company shall redeem all or any lesser portion of its then outstanding Preferred Shares. A Default Redemption Event shall be deemed to occur if the Company's corporate structure as a whole, including

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**18. Convertible redeemable preferred shares (Continued)**

***Redemption Right (Continued)***

without limitation the VIE documents, is invalidated or otherwise challenged by any PRC governmental authority, court or other official governmental body as a result of the application of or interpretation of the PRC law. In connection with the Series D Common Share Financing in January 2011, the Default Redemption Event was removed and the redemption date was changed to any time after June 30, 2015.

The redemption date above is subject to postponement until the Company meets the financial thresholds of having at least US\$3,000 of cash or cash equivalents on the balance sheet or the Company has generated over US\$1,000 in free cash flows in the preceding twelve months.

The redemption price of Series A Preferred Shares is equal to (i) the fair market value of the Series A Preferred Shares as of the redemption date, or (ii) 150% of the original issue price of Series A Preferred Shares, plus all declared or accrued but unpaid dividends up until the date of redemption, plus an amount that would give the holders of the Series A Preferred Shares an internal rate of return of no less than 10% per annum.

The redemption price of Series B Preferred Shares is equal to (i) the fair market value of the Series B Preferred Shares as of the redemption date, or (ii) 100% original issue price of Series B Preferred Shares, plus all declared or accrued but unpaid dividends up until the date of redemption, plus an amount that would give the holders of the Preferred Shares an internal rate of return of no less than 10%.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**18. Convertible redeemable preferred shares (Continued)**

***Redemption Right (Continued)***

The redemption price of Series C Preferred Shares is equal to (i) the fair market value of the Series C Preferred Shares as of the redemption date, or (ii) 100% original issue price of Series C-1 or C-2 Preferred Shares, plus all declared or accrued but unpaid dividends up until the date of redemption, plus an amount that would give the holders of the Series C-1 or C-2 Preferred Shares an internal rate of return of no less than 10% per annum.

***Modification***

Upon its issuance, Series A Preferred Shares were classified as permanent equity and were not redeemable. In association with the issuance of Series B Preferred Shares in August 2008, Series A Preferred Shares were granted redemption at the option of the holders and drag-along rights and accordingly were reclassified as mezzanine equity of the Company. The Company concluded that the addition of the redemption and drag-along rights is a modification of the terms of the Series A Preferred Shares. The incremental value received by the Series A Preferred Shareholders amounted to RMB916 which was deemed to be a wealth transfer between the preferred shareholders and the common shareholders and was charged to additional paid-in capital.

Upon its issuance, Series B Preferred Shares had a redemption right beginning on or after the seventh anniversary following the issuance of Series B Preferred Shares. In association of the issuance of Series C Preferred Shares, the redemption right for Series A and Series B Preferred Shares and drag along rights were amended. The Company concluded amendment of the redemption and drag-along rights is a modification of the terms of the Series A and Series B Preferred Shares. The incremental value received by Series A and Series B Preferred Shareholders amounted to RMB19 and RMB176, respectively, which were deemed to be a wealth transfer between the preferred shareholders and the common shareholders and were charged to additional paid-in capital.

***Accretion (Decretion)***

Due to the redemption features described above, the Company classified the Preferred Shares in the mezzanine equity section of the consolidated balance sheets. The Company recognized the changes in the redemption value immediately as they occurred and adjusted the carrying amount of the Preferred Shares to equal the redemption value at the end of each reporting period. The fair market values of the Preferred Shares as of December 31, 2010 and 2011 were greater than the redemption value as of December 31, 2009 and 2010, while the fair market value of the Preferred Shares prior to conversion on November 21, 2012 was lower than the redemption value as of December 31, 2011. As a result, the Company recorded accretion (decretion) to the redemption value immediately and adjusted the carrying amount of the instrument to equal to the redemption value at the end of each reporting period. The accretion was recorded against retained earnings, or in the absence of retained earnings, by charging against additional paid-in capital. Once additional paid-in capital has been exhausted, additional charges were recorded by increasing accumulated deficit. The decretion was recorded against the previous accretion originally recognized in retained earnings or additional paid-in capital, where applicable.



[Table of Contents](#)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****18. Convertible redeemable preferred shares (Continued)**

The following table sets forth the changes of each of the convertible redeemable preferred shares for years ended December 31, 2011, 2012 and 2013:

**Series A Preferred Shares**

	For the year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Beginning balance	846,752	935,013	
Accretion (decretion) to redemption value	88,261	(485,517)	
Conversion of convertible redeemable preferred shares into Class B common shares		(449,496)	
Ending balance		935,013	

**Series B Preferred Shares**

	For the year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Beginning balance	639,799	703,901	
Accretion (decretion) to redemption value	64,102	(366,785)	
Conversion of convertible redeemable preferred shares into Class B common shares		(337,116)	
Ending balance		703,901	

**Series C Preferred Shares**

	For the year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Beginning balance	770,720	842,020	
Accretion (decretion) to redeemable value	71,300	(441,573)	
Conversion of convertible redeemable preferred shares into Class B common shares		(400,447)	
Ending balance		842,020	



Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****18. Convertible redeemable preferred shares (Continued)**

Prior to the completion of the IPO, the Company engaged an independent valuation firm to assist them in determining the fair values of the preferred and common shares which were estimated as of the date of issuance and at each financial statement reporting date using the "Discounted Cash Flow Method", the "Guideline Transaction Method" and the "Backsolve Method", where methodologies, approaches and assumptions are consistent with the current working draft of the American Institute of Certified Public Accountants practice aid *Valuation of Privately Held Company Equity Securities Issued as Compensation*. The Guideline Transaction Method is a form of market approach based on the enterprise value to revenue multiples of the Group's own equity transactions close to the valuation date. The Backsolve Method is a form of market approach to valuation that derives the implied equity value for one type of equity security (e.g. common equity) from a contemporaneous transaction involving another type of equity security (e.g., preferred share). The Discounted Cash Flow Method, a form of income approach, estimates the fair value based on projected cash flows at each of the valuation dates. The followings are assumptions in the Discounted Cash Flow Method:

	<b>December 31, 2011</b>
Risk-free interest rate	2.53%
Volatility	66.1%
Dividend yield	
Discount rate	16%

The Company estimated the risk-free interest rate based on yield-to-maturities in continuous compounding of the China Government Bond with the time to maturities similar to the Preferred Shares. The Company estimated volatility at the dates of appraisal based on average of historical volatilities of the comparable companies in the same industry. The Company has no history or expectation of paying dividend on the Preferred Shares. Discount rate is estimated by weighted average cost of capital as at each appraisal date. In addition to the above assumptions adopted, the Company's projections of future performance were also factored into the determination of the fair value of each Preferred Share.

***Liquidity Preference***

In the event of any liquidation, dissolution or winding up of the Company or any deemed liquidation event (e.g., change in control), the holders of Series B Preferred Shares and Series C Preferred Shares were entitled to receive an amount per share equal to 100% of the original issuance price plus all dividends accrued, or declared and unpaid. Series A Preferred Shares were entitled to receive an amount per share equal to 150% of the original issuance price plus all declared or accrued but unpaid dividends.

If the assets and funds distributed among the holders are insufficient to permit the payment of the full preferential amounts, then the holders of Series C Preferred Shares shall be entitled to be paid first, followed in sequence by Series B Preferred Shares, Series A Preferred Shares and common shares. After payment of the full amounts from above, the remaining assets of the Company available for distribution shall be distributed ratably among the holders of preferred shares and common shares in proportion to the number of outstanding shares held by each holder on an as converted basis.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**18. Convertible redeemable preferred shares (Continued)**

*Dividends*

Each holder of Preferred Shares was entitled to receive dividends when and if declared by the Board of Directors of the Company. As long as the Preferred Shares were outstanding, the Company might not pay any dividend to common shareholders until all dividends declared and payable to the preferred shareholders had been paid. In the event the Company shall declare a dividend to the holders of common shares, then in each such case, the holders of the Preferred Shares shall be entitled to a proportionate share of such dividend on an as-converted basis.

*Voting rights*

Each Preferred Share conveys the right to the shareholder of one vote for each common share upon conversion.

**19. Share-based compensation**

**(a) Share options**

Pre-2009 Scheme Options

*Grant of options*

Before the adoption of the Employee Equity Incentive Scheme (the "2009 Incentive Scheme"), 12,705,700 and 8,499,050 share options were granted to employees through individually signed share option agreements, to acquire common shares of Duowan BVI on a one-to-one basis on January 1, 2008 and 2009 respectively. In addition, on January 1, 2008, 3,832,290 share options were granted to one non-employee for the provision of consulting services to the Group (collectively defined as "Pre-2009 Scheme Options").

*Vesting of options*

These Pre-2009 Scheme Options will vest over a four years' service period, with 25% of the options vesting after the first anniversary of the vesting inception date and the remaining 75% in six equal installments over the following 36 months. The options may be exercised provided that both the service conditions and a performance condition are met. The performance condition is defined to be i) an initial public offering, ii) completion of a financing meeting certain criteria, iii) an internal reorganization, or iv) a voluntary winding up of Duowan BVI. The performance condition that is tied to completion of a financing fulfilling certain criteria was met in June 2008 or November 2009.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****19. Share-based compensation (Continued)****(a) Share options (Continued)**

The following table summarizes the activities of the Pre-2009 Scheme Options for employees and non-employee for the years ended December 31, 2011, 2012 and 2013:

	Number of options	Weighted average exercise price (US\$)	Weighted average remaining contractual life (years)	Aggregate intrinsic value (US\$)
Outstanding, January 1, 2011	19,742,590	0.0056	7.39	18,372
Exercised/Repurchased <sup>(1)</sup>	(1,853,055)	0.0061		
Outstanding, December 31, 2011 <sup>(2)</sup>	17,889,535	0.0055	6.37	19,366
Forfeited	(19,110)	0.0067	6.25	
Outstanding, December 31, 2012	17,870,425	0.0055	5.37	12,642
Exercised	(4,648,420)	0.0045	4.30	
Outstanding, vested and exercisable December 31, 2013	13,222,005	0.0059	4.40	33,162

(1)

In connection with the Series D Common Share Financing (Note 17) in January 2011, certain employees and the non-employee were given the opportunity to cash-settle their vested options. The repurchase price of each vested option/share was the difference between the stated exercise price of the Pre-2009 Scheme Option and US\$0.9777, which was the per share issuance price of common shares issued to the new investor. A total of 1,853,055 Pre-2009 Scheme Options were exercised/repurchased by Duowan BVI for cash consideration of RMB11,701. The underlying common shares were cancelled immediately after the repurchase (the "Second Repurchase"). Similar offer was made by Duowan BVI to the non-employee holding the Pre-2009 Scheme Options but that non-employee did not take up the offer.

(2)

On September 15, 2011, the board of directors of the Company resolved not to undertake any repurchases of vested or unvested share-based compensation awards, except under those conditions specified in the relevant award scheme and grant documents. In addition, any proposed repurchase of vested or unvested share-based compensation awards should be approved by the majority votes of the board of directors. Such intention of the Company was specifically communicated to all employees with or without the awards. All the employees with vested or unvested awards also confirmed such understanding by a written confirmation. Accordingly, the classification of the liability-classified awards changed back to be equity-classified, and the related liability had been reclassified to additional paid-in capital on the modification date.

Forfeitures are estimated at the time of grant. If necessary, forfeitures are revised in subsequent periods if actual forfeitures differ from those estimates.

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The aggregate intrinsic value in the table above represents the difference between the Company's common shares as of December 31, 2011, 2012 and 2013 and the exercise price.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****19. Share-based compensation (Continued)****(a) Share options (Continued)**

Prior to the completion of the IPO, the Binomial option pricing model is used to determine the fair value of the share options granted to employees and the non-employee. The fair values of share options granted or remeasured during the year ended December 31, 2011 was estimated using the following assumptions:

Pre-2009 Scheme Options granted to employees and a non-employee:

	<b>2011</b>
Risk-free interest rate <sup>(1)</sup>	3.34%-4.01%
Expected term <sup>(2)</sup>	6-8 years
Volatility rate <sup>(3)</sup>	53.06%-55.34%
Dividend yield <sup>(4)</sup>	

- (1) The risk-free interest rate of periods within the contractual life of the share option is based on the China Government Bond yield as at the valuation dates.
- (2) The expected term is the contract life of the option.
- (3) Expected volatility is estimated based on the average of historical volatilities of the comparable companies in the same industry as at the valuation dates.
- (4) Duowan BVI and the Company have no history or expectation of paying dividend on its common shares. The expected dividend yield was estimated based on the Company's expected dividend policy over the expected term of the option.

Upon the completion of the IPO, the fair value of share options granted to a non-employee with nil exercise price was assessed to be equivalent to the fair value of the Company's common share. These share options were remeasured at the stock price of the Company's common share as of December 31, 2012 and 2013.

The total intrinsic value of options exercised during the year ended December 31, 2011, 2012 and 2013 amounted to RMB11,912, nil and RMB64,195, respectively. For the years ended December 31, 2011, 2012 and 2013, the Company recorded share-based compensation of RMB25,683, share-based benefit of RMB89 and share-based compensation of RMB14,004, respectively, using the graded-vesting attribution method for employees and non-employee.

As of December 31, 2013, there was no unrecognized compensation cost and expense related to Pre-2009 Scheme Options granted to employees and non-employee.

**(b) Restricted shares**

Since January 1, 2010, Duowan BVI granted 61,250,677 restricted shares to employees and 100,000 restricted shares to a non-employee pursuant to the 2009 Incentive Scheme. As of December 31, 2012, the restricted shares granted to the non-employee were fully vested.

*Vesting of restricted shares*

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The restricted shares have vesting conditions and will vest 50% after 24 months of the grant date and the remaining 50% will vest in two equal installments over the next 24 months. Under the restricted shares agreement, no shares may be sold or transferred prior to the occurrence of an exit event, as defined in the respective restricted share agreements as: i) a listing on any recognized stock exchange, ii) a sale by Duowan BVI of all or substantially all of its assets, iii) a sale of all of the issued capital of Duowan BVI, or iv) passing for court order of winding up of Duowan BVI.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****19. Share-based compensation (Continued)****(b) Restricted shares (Continued)**

If the employee terminates employment, the service vested portion of the restricted shares may be subject to: (i) repurchase (subject to Company's sole discretion) by Duowan BVI at fair value of common shares of Duowan BVI which is assessed by the Company with the assistance of an independent valuation firm; or (ii) be held by a person who is an existing employee of the Group and is designated by the leaving restricted share holder according to a properly signed escrow agreement to hold such shares for and on his/her behalf. If the leaving employee fails to deliver a properly signed agreement to Duowan BVI within 30 days from receipt of the notification from Duowan BVI, such service vested shares shall automatically lapse and expire.

The following table summarizes the restricted shares activity for the years ended December 31, 2011, 2012 and 2013:

	Number of restricted shares	Weighted average grant-date fair value (US\$)
Outstanding, January 1, 2011	48,486,036	0.2936
Granted	10,846,800	0.9362
Forfeited	(2,726,024)	0.3917
Vested	(13,321,711)	0.1636
Outstanding, December 31, 2011	43,285,101	0.4885
Forfeited	(3,673,580)	0.4945
Vested	(21,380,720)	0.4864
Outstanding, December 31, 2012	18,230,801	0.4898
Forfeited	(1,581,789)	0.8726
Vested	(11,975,287)	0.3906
Outstanding, December 31, 2013	4,673,725	0.6144
Expected to vest at December 31, 2013	4,449,366	0.6120

Forfeitures are estimated at the time of grant. If necessary, forfeitures are revised in subsequent periods if actual forfeitures differ from those estimates.

For the years ended December 31, 2011, 2012 and 2013, the Company recorded share-based compensation of RMB57,805, RMB36,371 and RMB7,300, respectively, using the graded-vesting method for employees and non-employee.

As of December 31, 2013, total unrecognized compensation expense relating to the restricted shares was RMB5,873. The expense is expected to be recognized over a weighted average period of 0.54 years using the graded vesting attribution method.

**(c) Share-based awards granted to CEO and Chairman of the Company**

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On February 23, 2010, the CEO and the Chairman of the Company, also directors and shareholders were granted 13,369,813 and 29,678,483 restricted shares, respectively. The Chairman's shares have a service condition that vest over a four year period (50% after the second anniversary and 25% each year thereafter). Both the CEO's and the Chairman's shares are subject to a performance condition which relates to the number of peak concurrent users on the YY Client. Such performance condition was met as of December 31, 2010.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****19. Share-based compensation (Continued)****(c) Share-based awards granted to CEO and Chairman of the Company (Continued)**

Pursuant to the provisions stipulated in the grant document relating to these restricted shares grant, upon the occurrence of an Acceleration Event, the restricted shares granted to the Chairman would also become fully vested. An "Accelerated Event" is defined as (i) a Listing, (ii) a sale of all or substantially all of the issued share capital of Duowan BVI, (iii) a sale by Duowan BVI of all or substantially all of its assets, (iv) the passing of an effective resolution or the making of an order of a competent court for the winding up of Duowan BVI.

The following table summarizes information regarding the restricted shares granted to the CEO and the Chairman:

	Number of restricted shares	Weighted average grant-date fair value (US\$)
Outstanding, January 1, 2011	29,678,483	0.1875
Outstanding, December 31, 2011	29,678,483	0.1875
Vested	(29,678,483)	0.1875

Outstanding, December 31, 2012 and 2013

The fair value of the share-based awards above was determined at the respective grant dates by the Company with the assistance of an independent valuation firm.

The Company recognized these awards as employee share-based compensation awards using fair value of the awards on the grant date. As of December 31, 2010, the performance condition was met. The compensation expense for the CEO's restricted shares was fully recognized and the compensation expense for the Chairman's restricted shares is recognized over the requisite service period using the graded vesting method. Upon the completion of the IPO, the restricted shares granted to the Chairman were fully vested and all remaining compensation expenses were recognized immediately.

The total fair value of restricted shares vested during the year ended December 31, 2011, 2012 and 2013 amounted to nil, RMB35,924 and nil, respectively.

Share-based compensation expenses related to the awards granted to the CEO and Chairman of RMB14,143, RMB9,624 and nil were recognized in general and administrative expenses in the consolidated statements of operations for the years ended December 31, 2011, 2012 and 2013.

As of December 31, 2013, there was no unrecognized compensation cost and expense related to the restricted shares.

**(d) Share-based awards for former NeoTasks employees**

On December 5, 2008, Duowan BVI granted the two founders of NeoTasks, 26,873,070 warrants to acquire common shares of Duowan BVI in connection with the NeoTasks acquisition for post-combination services at an exercise price of US\$0. In October 2009, the Company converted the warrants into restricted shares having the same rights and vesting conditions as the original warrant grants. Accordingly, no incremental charge was recognized in the conversion. The shares were issued to the holders and legally registered in July 2010.



Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****19. Share-based compensation (Continued)****(d) Share-based awards for former NeoTasks employees (Continued)**

The awards shall vest over the earlier of (i) a three-year period, with one-third of the shares vesting annually or (ii) upon any sale, merger, amalgamation, liquidation or listing of Duowan BVI or the sale by Duowan BVI of all or substantially all of its assets (the "Awards to NeoTasks Founders").

The following table summarizes information regarding the share-based award granted:

	<b>Number of restricted shares</b>
Outstanding, January 1, 2011	8,957,690
Vested	(8,957,690)

Outstanding, December 31, 2011, 2012 and 2013

(1)

In connection with the First Repurchase occurred in November 2009, Duowan BVI repurchased a portion of their vested restricted shares by utilizing a portion of the proceeds obtained from the Series C preferred shares issuance. The negotiation and execution of the First Repurchase had formed an expectation to the holders of Awards to NeoTasks Founders that it was a practice of Duowan BVI to repurchase the vested restricted shares held by them. The Awards to NeoTasks Founders were deemed to be tainted and they were no longer equity-classified awards but liabilities-classified awards effective from November 2009. The awards would be re-measured at the end of each reporting period until either the repurchase obligation was extinguished or the awards holders were exposed to fluctuation of the market value of the shares for a period of at least six months, or the awards are settled, cancelled or expire unexercised.

The fair value of the restricted shares above was determined at the grant date. Effective from the re-designation of the award as liability-classified, it was re-measured at the end of each reporting date by the Company with the assistance of an independent valuation firm. The change in fair value was recognized in the consolidated statements of operations. After the award was changed back to equity-classified awards, it was measured based on the fair value of the awards on September 15, 2011, and the expenses to be recognized over the remaining requisite service period using the graded-vesting attribution method.

Share-based compensation expenses related to the above share-based award of RMB27,726 were recognized in general and administrative expenses in the consolidated statements of operations for the year ended December 31, 2011.

As of December 31, 2011, the compensation costs related to restricted shares for NeoTasks acquisition had been fully recognized.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****19. Share-based compensation (Continued)****(e) Restricted Share Units**

On September 16, 2011, the Board of the Directors of the Company approved the 2011 Share Incentive Plan, which permits the grant of share options, restricted shares and restricted share units of up to 43,000,000 shares, to any qualified persons, as determined by the Board of the Directors of the Company. On the same date, the Company granted 9,097,000 restricted share units to employees pursuant to the 2011 Share Incentive Plan, that are subject to vesting over a four to five years' period. During the year ended December 31, 2012, the Company granted 18,295,221 restricted share units to employees pursuant to the 2011 Share Incentive Plan, which are subject to vesting over a two to four years' period. No restricted share units were granted to non-employees up to December 31, 2012.

In October 2012, the Board of Directors of the Company resolved that the maximum aggregate number of Class A common shares which may be issued pursuant to all awards under the 2011 Incentive Scheme shall be 43,000,000 plus an annual increase of 20,000,000 on the first day of each fiscal year, beginning from 2013, or such lesser amount of Class A common shares as determined by the Board of Directors of the Company.

During the year ended December 31, 2013, the Company granted 29,917,989 restricted share units to employees and 48,000 restricted share units to non-employee pursuant to the 2011 Share Incentive Plan, which are subject to vesting over a three to five years' period.

The following table summarizes the restricted share units activity for the years ended December 31, 2011, 2012 and 2013:

	Number of restricted shares	Weighted average grant-date fair value (US\$)
Outstanding, January 1, 2011		
Granted	9,097,000	1.0630
Forfeited	(100,700)	1.0630
Outstanding, December 31, 2011	8,996,300	1.0630
Granted	18,295,221	1.0324
Forfeited	(595,900)	1.0876
Outstanding, December 31, 2012	26,695,621	1.0415
Granted	29,965,989	0.9338
Forfeited	(3,522,992)	1.0699
Vested	(8,836,018)	1.0429
Outstanding, December 31, 2013	44,302,600	0.9639
Expected to vest at December 31, 2013	41,581,339	0.9654

For the years ended December 31, 2011, 2012 and 2013, the Company recorded share-based compensation of RMB9,644, RMB54,445 and RMB95,792, using the graded-vesting attribution method.

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As of December 31, 2013, total unrecognized compensation expense relating to the restricted share units was RMB144,499. The expense is expected to be recognized over a weighted average period of 1.36 years using the graded-vesting attribution method.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**19. Share-based compensation (Continued)****(f) Movements of equity-classified and liability-classified awards**

The table below shows the movements and details of various equity-classified and liability-classified awards granted by the Company to its employees and non-employee for the years ended December 31, 2011, 2012 and 2013:

	Equity-classified Awards (RMB)						Liability-classified Awards (RMB)			
	2011	2011	2011	2011	2011	2011	2011	2011	2011	2011
	Pre-2009 Scheme options	2009 Incentive Scheme restricted shares	Incentive Scheme restricted share units	Share-based awards to CEO and Chairman	Share-based awards to Neo Founders	Share-based awards to Tasks Sub-total	Pre-2009 Scheme options	Awards to Neo Founders	Awards to Tasks Sub-total	Total
Balance as of January 1, 2011		24,525		30,808		55,333	109,035	94,089	203,124	258,457
Share-based compensation expenses	2,219	57,805	9,644	14,143	3,359	87,170	23,464	24,367	47,831	135,001
Exercised/Repurchased							(11,701)		(11,701)	(11,701)
Reclassifications										
From liability-awards to common share*								(57,692)	(57,692)	(57,692)
From liability-awards to equity awards**	116,328				57,602	173,930	(116,328)	(57,602)	(173,930)	
Foreign currency translation adjustment							(4,470)	(3,162)	(7,632)	(7,632)
Balance as of December 31, 2011	118,547	82,330	9,644	44,951	60,961	316,433				316,433
Balance as of January 1, 2012	118,547	82,330	9,644	44,951	60,961	316,433				316,433
Share-based compensation expenses	(89)	36,371	54,445	9,624		100,351				100,351
Balance as of December 31, 2012	118,458	118,701	64,089	54,575	60,961	416,784				416,784
Balance as of January 1, 2013	118,458	118,701	64,089	54,575	60,961	416,784				416,784
Share-based compensation expenses	14,004	7,300	95,792			117,096				117,096
Balance as of December 31, 2013	132,462	126,001	159,881	54,575	60,961	533,880				533,880



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\*

During the year ended December 31, 2011, the restricted shares to NeoTasks founders were held by NeoTasks Founders for more than six months, therefore, the related awards amounting to RMB57,692 were reclassified back to common share.

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As detailed in Note 19(a) and (d), the share options and the restricted shares to NeoTasks founders were reclassified from liability-classified awards to equity-classified awards in September 2011, accordingly.

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(All amount in thousands, except share and per share data, unless otherwise stated)

**20. Basic and diluted net (loss) income per share**

Basic and diluted net (loss) income per share for the years ended December 31, 2011, 2012 and 2013 are calculated as follows:

	For the year ended December 31,		
	2011 RMB	2012 RMB	2013 RMB
<b>Numerator:</b>			
Net (loss) income attributable to the Company	(83,156)	89,177	477,727
(Accretion) decrement to convertible redeemable preferred shares redemption value	(223,663)	1,293,875	
Allocation of net income to participating preferred shareholders		(478,754)	
<b>Numerator of basic net (loss) income per share</b>	<b>(306,819)</b>	<b>904,298</b>	<b>477,727</b>
Dilutive effect of preferred shares		(815,121)	
<b>Numerator for diluted (loss) income per share</b>	<b>(306,819)</b>	<b>89,177</b>	<b>477,727</b>
<b>Denominator:</b>			
<b>Denominator for basic calculation weighted average number of Class A and Class B common shares outstanding</b>	<b>485,883,845</b>	<b>604,703,810</b>	<b>1,122,475,688</b>
Dilutive effect of preferred shares		320,142,965	
Dilutive effect of share options		17,782,885	16,362,048
Dilutive effect of restricted shares		30,594,877	14,400,670
Dilutive effect of restricted share units		4,802,491	27,882,891
Dilutive effect of share-based awards granted to CEO and Chairman		14,441,808	
<b>Denominator for diluted calculation</b>	<b>485,883,845</b>	<b>992,468,836</b>	<b>1,181,121,297</b>
<b>Basic net (loss) income per Class A and Class B common share</b>	<b>(0.63)</b>	<b>1.50</b>	<b>0.43</b>
<b>Diluted net (loss) income per Class A and Class B common share</b>	<b>(0.63)</b>	<b>0.09</b>	<b>0.40</b>
<b>Basic net (loss) income per ADS*</b>	<b>(12.63)</b>	<b>29.91</b>	<b>8.51</b>
<b>Diluted net (loss) income per ADS*</b>	<b>(12.63)</b>	<b>1.80</b>	<b>8.09</b>

\*

The Company was listed on November 21, 2012 with issuance of a total of 8,970,000 ADS at a public offering price of US\$10.50 per ADS. Each ADS represents 20 Class A common shares. The net (loss) income per ADS for the years ended December 31, 2011, 2012 and 2013 were calculated using the same conversion ratio assuming the ADSs had been in existence during these periods.

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The Company's preferred shares are participating securities and as such would be included in the calculation of basic earnings per share under the two-class method. According to the contractual terms of the preferred shares, the preferred shares do not have a contractual obligation to share in the losses of the Company. Therefore, no loss was allocated to the preferred shares in the computation of basic net loss per share for the year ended December 31, 2011. Net income was allocated to the preferred shares in the computation of basic net income per share for the year ended December 31, 2012.

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Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****20. Basic and diluted net (loss) income per share (Continued)**

The Preferred Shares, share-based awards for former NeoTasks employees, the share-based awards granted to the CEO and Chairman, share option, restricted shares, restricted share units and warrants to an independent institutional investor were excluded from the computation of diluted net loss per common share for the year ended December 31, 2011 because including them would have had an anti-dilutive effect. The following table summarizes information regarding weighted average of common shares equivalents for the year ended December 31, 2011:

	<b>For the year ended December 31, 2011</b>
Preferred shares weighted average	359,424,310
Share-based awards for NeoTasks acquisition weighted average	8,319,608
Share-based awards granted to CEO and Chairman weighted average	29,678,483
Share options weighted average	18,488,604
Restricted shares weighted average	54,045,124
Restricted share units weighted average	2,625,039
Warrants to an independent institutional investor weighted average	12,609,970

**21. Related party transactions**

The table below sets forth the related parties and their relationships with the Group:

<b>Related Party</b>	<b>Relationship with the Group</b>
Zhuhai Daren Computer Technology Company Limited ("Zhuhai Daren")	Equity investment
Guangzhou Shanghang Information Technical Co., Ltd. ("Shanghang")	Significant influence exercised by the Chairman
Kingsoft Corporation ("Kingsoft")	Significant influence exercised by the Chairman
Xiaomi Corporation ("Xiaomi")	Significant influence exercised by the Chairman
Zhuhai Lequ Technology Co., Ltd. ("Zhuhai Lequ")	Equity investment
Agora, Inc. <sup>(1)</sup>	Controlled by the director and the chairman of technology committee of the Group

(1)

In December 2013, the Group made a minority interest investment to form a new company, Agora, Inc., with the director and the chairman of technology committee of the Group and other strategic investors.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(All amount in thousands, except share and per share data, unless otherwise stated)

**21. Related party transactions (Continued)**

During the years ended December 31, 2011, 2012 and 2013, significant related party transactions were as follows:

	For the year ended December 31,		
	2011 RMB	2012 RMB	2013 RMB
Online games revenue sharing from Zhuhai Daren	4,451	7,547	24,452
Bandwidth service provided by Shanghang	21,985	11,776	21,272
Purchase of intangible assets from Kingsoft			6,010
Online games revenue sharing from Zhuhai Lequ			5,076
Advertising revenue from Xiaomi			1,154
Repayment of interest-free loan from Zhuhai Lequ		500	1,000
Membership subscription fee revenue from Xiaomi		227	
Interest-free loan to Zhuhai Daren	500		
Repayment of interest-free loan from Zhuhai Daren		2,000	
Interest-free loan to Zhuhai Lequ		1,200	
Disposal of a cost investment to the Chairman and Co-founder, who is also a director of the Company		1,000	
Disposal of an equity investment to Xiaomi		2,000	

As of December 31, 2012 and 2013, the amounts due from/to related parties were as follows:

	December 31,	
	2012 RMB	2013 RMB
<b>Amount due from a related party</b>		
Other receivables from Zhuhai Lequ	1,073	73
<b>Total</b>	<b>1,073</b>	<b>73</b>

<b>Amounts due to related parties</b>		
Accounts payable to Zhuhai Daren	2,362	1,479
Other payables to Shanghang	242	822
Accounts payable to Zhuhai Lequ		339
<b>Total</b>	<b>2,604</b>	<b>2,640</b>

The other receivables/payables from/to related parties are unsecured, interest-free and payable on demand.

**22. Fair value measurements**

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Fair value reflects the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Group considers the principal or most advantageous market in which it would transact and considers assumptions that market participants would use when pricing the assets or liabilities.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**22. Fair value measurements (Continued)**

The Group applies a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. This guidance specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level 1 Valuation techniques in which all significant inputs are unadjusted quoted prices from active markets for assets or liabilities that are identical to the assets or liabilities being measured.

Level 2 Valuation techniques in which significant inputs include quoted prices from active markets for assets or liabilities that are similar to the assets or liabilities being measured and/or quoted prices for assets or liabilities that are identical or similar to the assets or liabilities being measured from markets that are not active. Also, model-derived valuations in which all significant inputs and significant value drivers are observable in active markets are Level 2 valuation techniques.

Level 3 Valuation techniques in which one or more significant inputs or significant value drivers are unobservable. Unobservable inputs are valuation technique inputs that reflect the Group's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair value guidance describes three main approaches to measure the fair value of assets and liabilities: (1) market approach; (2) income approach and (3) cost approach. The market approach uses prices and other relevant information generated from market transactions involving identical or comparable assets or liabilities. The income approach uses valuation techniques to convert future amounts to a single present value amount. The measurement is based on the value indicated by current market expectations about those future amounts. The cost approach is based on the amount that would currently be required to replace an asset.

When available, the Group uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Group will measure fair value using valuation techniques that use, when possible, current market-based or independently sourced market parameters, such as interest rates and currency rates. The Group did not have any financial instruments that were required to be measured at fair value on a recurring basis as of December 31, 2012 and 2013.

The Group's financial instruments consist principally of cash, short-term deposits, accounts receivable, amounts due to/from related parties, accounts payable and certain accrued expenses. The recorded values of cash, accounts receivable, amounts due to/from related parties, accounts payable and certain accrued expenses are recorded at cost which approximates fair value.

**23. Commitments and contingencies**

**(a) Operating lease commitments**

The Group leases facilities in the PRC under non-cancellable operating leases expiring on different dates. Payments under operating leases are expensed on a straight-line basis over the periods of the respective leases.

Total office rental expenses under all operating leases were RMB6,361, RMB16,670 and RMB19,423 for the years ended December 31, 2011, 2012 and 2013, respectively.

Table of Contents**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(All amount in thousands, except share and per share data, unless otherwise stated)****23. Commitments and contingencies (Continued)****(a) Operating lease commitments (Continued)**

As of December 31, 2013, future minimum payments under non-cancellable operating leases consist of the following:

	<b>Office rental</b>
	<b>RMB</b>
2014	16,919
2015	15,809
	32,728

**(b) Capital commitment**

As of December 31, 2013, the Group did not have any capital commitment.

**(c) Litigation**

The Group is not currently a party to, nor is aware of, any legal proceeding, investigation or claim which individually or in the aggregate is likely to have a material adverse effect on the Group's business, financial condition, results or operations, or cash flows. The Group did not record any legal contingencies as of December 31, 2013.

**24. Subsequent events**

In February 2014, The Group has initiated a lawsuit against one of the Group's advertisement agents, claiming for the unpaid advertisement fee and liquidated damages for late payment. Management believed that the lawsuit did not have significant impact to the Group's financial statements as of December 31, 2013.

**25. Restricted net assets**

Relevant PRC laws and regulations permit payments of dividends by the Group's subsidiaries and the VIEs and VIE's subsidiary incorporated in the PRC only out of their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. In addition, the Company's subsidiaries and the VIEs and VIE's subsidiary in the PRC are required to annually appropriate 10% of their net after-tax income to the statutory general reserve fund prior to payment of any dividends, unless such reserve funds have reached 50% of their respective registered capital. As a result of these and other restrictions under PRC laws and regulations, the Group's subsidiaries and the VIEs and VIE's subsidiary incorporated in the PRC are restricted in their ability to transfer a portion of their net assets to the Company either in the form of dividends, loans or advances, which restricted portion as calculated under US GAAP amounted to approximately RMB311,399 and RMB303,366 as of December 31, 2012 and 2013, respectively. There are no differences between US GAAP and PRC accounting standards in connection with the reported net assets of the legally owned subsidiaries in the PRC and the VIEs and VIE's subsidiary. Even though the Company currently does not require any such dividends, loans or advances from the PRC entities for working capital and other funding purposes, the Company may in the future require additional cash resources from them due to changes in business conditions, to fund future acquisitions and development, or merely to declare and pay





**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(All amount in thousands, except share and per share data, unless otherwise stated)**

**25. Restricted net assets (Continued)**

dividends or distributions to our shareholders. Except for the above, there is no other restriction on use of proceeds generated by the Group's subsidiaries and the VIEs and VIE's subsidiary to satisfy any obligations of the Company.

The Company performed a test on the restricted net assets of consolidated subsidiaries and VIEs in accordance with Securities and Exchange Commission Regulation S-X Rule 4-08 (e) (3), "General Notes to Financial Statements" and concluded that the restricted net assets did not exceed 25% of the consolidated net assets of the Company as of December 31, 2013 and the condensed financial information of the Company are not required to be presented.

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