Giant Interactive Group Inc.
Form 20-F/A
September 26, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549.

AMENDMENT NO. 1

TO

FORM 20-F

(Mark One)

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

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2011

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to .

OR

¨ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Date of event requiring this shell company report

Commission file number: 001-33759

Giant Interactive Group Inc.

(Exact name of Registrant as specified in its charter)

Not applicable

(Translation of Registrant s name into English)

Cayman Islands

(Jurisdiction of incorporation or organization)

11/F, No. 3 Building, 700 Yishan Road

Shanghai, 200233, People s Republic of China

(Address of principal executive offices)

Jazy Zhang Chief Financial Officer

11/F, No. 3 Building, 700 Yishan Road

Shanghai, 200233,

People s Republic of China

Telephone: (86 21) 3397 9999

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(Name, Telephone, E-mail and/or Facsimile Number and Address of Company Contact Person)

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

Title of each class	Name of each exchange on which registered
American Depositary Shares, each representing one ordinary share, par value US$0.0000002 per share	New York Stock Exchange

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

None

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

None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report: 235,234,959 ordinary shares.

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

If this report is an annual or transaction report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. ¨ Yes x No

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. x 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). x Yes ¨ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP x International Financial Reporting Standards as issued by the International Accounting Standards Board ¨ Other ¨

If Other has been checked in response to the previous question indicate by check mark which financial statement item the registrant has elected to follow. ¨ Item 17 ¨ Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes x No

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EXPLANATORY NOTE

This amendment no. 1 on Form 20-F/A hereby amends Items 3, 5, 8, 17, 18 and 19 of Giant Interactive Group Inc. s annual report on Form 20-F for the fiscal year ended December 31, 2011, which was filed on April 23, 2012. This amendment no. 1 is being filed for the purpose of providing additional details to our disclosures in the original report as well as providing additional clarifying information in the notes to our financial statements pursuant to comments we received from the Staff of the U.S. Securities and Exchange Commission in connection with its review of our periodic filings. This amendment no. 1 is not intended to revise other information presented in our annual report on Form 20-F for the fiscal year ended December 31, 2011 as originally filed, which remains unchanged.

This amendment no. 1 on Form 20-F/A does not reflect events occurring after the filing of the original Form 20-F and does not modify or update the disclosure therein in any way other than as required to reflect the amendments discussed above. As a result, this amendment no. 1 to the annual report on Form 20-F/A continues to speak as of April 23, 2012, except for Notes 2, 3, 9, 13 and 17 to the Item 17 and 18 Financial Statements, as to which the date is September 26, 2012.

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FORWARD-LOOKING STATEMENTS

This amendment no. 1 on Form 20-F/A contains forward-looking statements that relate to our current expectations and views of future events. The forward-looking statements are contained principally in the items entitled Information on the Company, Risk Factors, Operating and Financial Review and Prospects, and Financial Information . Our forward-looking statements relate to events that involve known and unknown risks, uncertainties and other factors, including those listed under Risk Factors, which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements.

In some cases, these forward-looking statements can be identified by words or phrases such as may, will, expect, anticipate, aim, estimate, intend, plan, believe, potential, continue, is/are likely to or other similar expressions. We have based these forward-looking statements lar our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements include, among other things, statements relating to:

- our anticipated growth and marketing strategies;
- our future business development, results of operations and financial condition;
- our ability to develop and commercialize new online games, including our ability to manage our development expenses;
- market acceptance of our online games;
- our ability to introduce expansion packs and updates to our existing online games;
- our ability to license our online games to third party operators;
- our ability to manage our existing licensing arrangements, including our ability to anticipate and manage licensing fees;
- competition from other online game developers and operators;
- our ability to anticipate and manage internet access fees and server maintenance costs;
- our intentions regarding management of our employees and liaison personnel;
- our ability to comply with regulation applying to online games;
- our ability to effectively protect our existing and future intellectual property and not to infringe on the intellectual property of others;

- our ability to expand our business through organic growth and strategic acquisitions;

- fluctuations in general economic and business conditions in China; and

- impact of the current worldwide economic crisis on our business.

If any one or more of the assumptions underlying the market data turns out to be incorrect, actual results may differ from the projections based on these assumptions. You should not place undue reliance on these forward-looking statements.

The forward-looking statements made in this annual report relate only to events or information as of the date on which the statements are made in this annual report. Except as required by law, we undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, after the date on which the statements are made or to reflect the occurrence of unanticipated events. You should read this annual report and the documents that we reference in this annual report completely and with the understanding that our actual future results may be materially different from what we expect.

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PART I.

ITEM 3. KEY INFORMATION

A. Selected Financial Data

The selected consolidated financial data for the three years ended December 31, 2009, 2010, and 2011, and the selected consolidated balance sheet data as of December 31, 2010 and 2011, were derived from our consolidated financial statements, which have been audited by Ernst & Young Hua Ming LLP, an independent registered public accounting firm. The report of Ernst & Young Hua Ming LLP, as well as our audited consolidated financial statements as of December 31, 2010 and 2011, and for each of the three years ended December 31, 2011, are included elsewhere in this annual report. The selected consolidated balance sheet data as of December 31, 2007 and 2008, and selected consolidated statement of operations and comprehensive income data for the years ended December 31, 2007 and 2008, have been derived from our audited consolidated financial statements for the years ended December 31, 2007 and 2008, which are not included in this annual report.

Our consolidated financial statements are prepared and presented in accordance with U.S. GAAP. Our historical results do not necessarily indicate our results expected for any future periods. You should read the selected consolidated financial data in conjunction with the consolidated financial statements and the related notes included under Item 18. Financial Statements and Item 5. Operating and Financial Review and Prospects

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Consolidated Statement of Operations and Comprehensive Income Data:

	Year Ended December 31,					
	2007	2008	2009	2010	2011	
	RMB	RMB	RMB	RMB	RMB	US$
	(In thousands, except per share and per ADS data)					
Net revenue:						
Online games	1,521,396	1,589,676	1,293,018	1,289,481	1,701,343	270,316
Licensing revenues	6,140	4,391	10,687	42,667	54,538	8,665
Other revenue, net		612	130	668	36,336	5,773
Total net revenue	1,527,536	1,594,679	1,303,835	1,332,816	1,792,217	284,754
Cost of services	(174,086)	(217,899)	(204,070)	(199,122)	(257,246)	(40,872)
Gross profit	1,353,450	1,376,780	1,099,765	1,133,694	1,534,971	243,882
Operating (expenses) income:						
Research and product development	(26,918)	(88,539)	(113,354)	(186,037)	(230,209)	(36,577)
Sales and marketing	(189,403)	(241,575)	(119,600)	(143,006)	(169,982)	(27,007)
General and administrative	(74,130)	(141,786)	(121,446)	(119,447)	(103,727)	(16,481)
Government financial incentives	16,779	63,084	88,460	57,386	47,746	7,586
Impairment of intangible assets				(46,558)		
Total operating expenses	(273,672)	(408,816)	(265,940)	(437,662)	(456,172)	(72,479)
Income from operations	1,079,778	967,964	833,825	696,032	1,078,799	171,403
Interest income	53,878	184,964	102,200	136,098	141,587	22,496
Investment income (loss)	2,562	1,171	(5,971)		3,048	484
Unrealized loss on investment held-for-trading		(300)				
Other (expense) income, net	126	(843)	14,025	65,466	43,558	6,921
Income before income tax expenses	1,136,344	1,152,956	944,079	897,596	1,266,992	201,304
Income tax expenses		(39,368)	(85,060)	(89,322)	(352,378)	(55,987)
Share of loss of an equity investee				(648)	(8,218)	(1,306)
Net income	1,136,344	1,113,588	859,019	807,626	906,396	144,011
Net loss (income) attributable to non controlling interests			295	3,563	(26,429)	(4,199)
Net income attributable to the Company s shareholders	1,136,344	1,113,588	859,314	811,189	879,967	139,812
Other comprehensive loss, net of tax						
Foreign currency translation	(51,927)	(192,424)	(12,769)	(73,194)	(84,728)	(13,462)
Reclassification adjustment			(1,814)			
Unrealized holding gains (losses)		76,969	(30,951)	(14,540)	(15,998)	(2,542)
Total other comprehensive loss, net of tax	(51,927)	(115,455)	(45,534)	(87,734)	(100,726)	(16,004)
Comprehensive income	1,084,417	998,133	813,780	723,455	779,241	123,808
Net earnings per ordinary shares, basic	5.40	4.65	3.80	3.57	3.79	0.60
Net earnings per ordinary shares, diluted	5.25	4.49	3.67	3.47	3.79	0.60

Net earnings per ADS[1], basic	5.40	4.65	3.80	3.57	3.79	0.60
Net earnings per ADS, diluted	5.25	4.49	3.67	3.47	3.79	0.60
Shares used in computation, basic	210,574,196	239,458,633	226,278,227	227,308,854	232,004,879	232,004,879
Shares used in computation, diluted	216,255,503	247,895,076	233,960,556	233,928,400	232,004,879	232,004,879

(1) Each ADS represents one ordinary share

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Selected Consolidated Balance Sheet Data:

	Year Ended December 31					
	2007 (RMB)	2008 (RMB)	2009 (RMB)	2010 (RMB)	2011 (RMB)	2011 (US$)
	(in thousands)					
Assets						
Cash and cash equivalents[1]	7,295,470	1,696,273	1,097,155	2,776,936	950,321	150,991
Short-term investments[1]		3,371,828	3,802,050	3,253,362	919,775	146,138
Total current assets[1]	7,373,495	5,236,061	5,102,972	6,304,005	2,179,246	346,247
Property and equipment, net	127,631	213,905	178,670	143,286	349,668	55,557
Investment in equity investees[2]				35,126	351,400	55,832
Total non-current assets	214,228	766,363	1,349,690	804,138	1,371,985	217,987
Total assets	7,587,723	6,002,424	6,452,662	7,108,143	3,551,231	564,234
Deferred revenue	324,971	403,130	321,291	442,795	529,204	84,082
Total current liabilities	1,282,199	603,608	547,448	700,314	1,014,916	161,254
Total liabilities	**1,282,199**	**629,294**	**547,869**	**700,500**	**1,029,798**	**163,618**
Total Giant Interactive Group Inc. s equity	6,305,524	5,373,130	5,897,185	6,392,860	2,495,648	396,519
Non controlling interest			7,608	14,783	25,785	4,097
Total liabilities and equity	7,587,723	6,002,424	6,452,662	7,108,143	3,551,231	564,234

(1) In the third quarter of 2011, we declared and paid out a special dividend of US$3.00 per share to our ADS and ordinary share shareholders, out of which the payout was physically financed partially through the declaration and payout of dividends to the Company by one of its PRC subsidiaries. As such, the dividends were subject to a 10% withholding tax and therefore, we accrued a one-time withholding income tax amount of RMB259.4 million (US$41.2 million) associated with the repatriation of cash for the special dividend paid during the third quarter 2011.

(2) In September 2011, we invested US$50.0 million in the Yunfeng e-Commerce Funds for the purpose of purchasing shares of the Alibaba Group, China s leading e-commerce company.

Exchange Rate Information

Our business is conducted in China and substantially all of our net revenues are denominated in Renminbi. This annual report contains translations of Renminbi amounts into U.S. dollars at specific rates solely for the convenience of the reader. Conversions of Renminbi into U.S. dollars in this annual report are based on the noon buying rate in The City of New York for cable transfers of Renminbi as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise noted, all translations from Renminbi to U.S. dollars and from U.S. dollars to Renminbi in this annual report were made at a rate of RMB 6.2939 to US$1.00, the noon buying rate in effect as of December 31, 2011. We make no representation that any Renminbi or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Renminbi, as the case may be, at any particular rate, the rates stated below, or at all. The PRC government imposes control over its foreign currency reserves in part through direct regulation of the conversion of Renminbi into foreign exchange and through restrictions on foreign trade. On April 13, 2012, the noon buying rate was RMB6.3022 to US$1.00.

The following table sets forth information concerning exchange rates between the Renminbi and the U.S. dollar for the periods indicated.

	Noon Buying Rate			
Period	Period End	Average[1]	Low	High
	(RMB per US$1.00)			
2007	7.2946	7.5806	7.2946	7.8127

2008	6.8225	6.9477	6.7800	7.2946
2009	6.8259	6.8307	6.8176	6.8470
2010	6.6000	6.7696	6.6000	6.8330
2011	6.2939	6.4475	6.2939	6.6364
October 2011	6.3547	6.3710	6.3534	6.3825
November 2011	6.3765	6.3564	6.3400	6.3839
December 2011	6.2939	6.3482	6.2939	6.3733
2012				
January 2012	6.3080	6.3119	6.2940	6.3330
February 2012	6.2935	6.2997	6.2935	6.3120
March 2012	6.2975	6.3125	6.2975	6.3315
April 2012 (through April 13, 2012)	6.3022	6.3048	6.2975	6.3123

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(1) Averages for a period are calculated by using the average of the exchange rates on the end of each month during the period. Monthly averages are calculated by using the average of the daily rates during the relevant period.

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Risks Relating to Our Business and Industry

The ZT Online franchise of massively multiplayer online role playing games, or MMORPGs, have historically accounted for substantially all of our net revenues. Any decrease in the popularity of these games would materially and adversely affect our results of operations.

The ZT Online franchise, which consists of the ZT Online 1 Series and ZT Online 2, have historically accounted for a significant portion of our net revenues. In 2006 we commercially launched ZT Online, which together with ZT Online PTP, ZT Online Classic Edition, and ZT Online Green Edition, constitutes the ZT Online 1 Series. In 2011 we commercially launched ZT Online 2, which is part of the ZT Online franchise but differs from the ZT Online 1 Series games in a number of ways, including its story, gameplay, graphics, maps, quests, and characters. The most significant change in ZT Online 2 is its in-game economy. ZT Online 2 s next generation in-game economy, the transaction-based revenue model which allows players to purchase in-game items from other players that have earned such items by leveling up their in-game characters and accomplishing in-game objectives, is designed to target lower spending and non-spending users as compared to that of ZT Online 1 Series, in which revenue is generated from the players consumption of game points to purchase items sold by the in-game store. Although we currently operate eleven games, six of which are not part of the ZT Online franchise, we expect that we will continue to derive substantially all of our net revenues from the ZT Online franchise in the near term. Our business prospects, financial condition and results of operations would therefore be materially and adversely affected by any factor that contributes to a decline in revenue from the ZT Online franchise, including:

- any reduction in purchases of virtual items by players of the ZT Online franchise games;
- any decrease in the popularity of the ZT Online 1 Series or ZT Online 2 due to competition or otherwise;
- failure to improve, update or enhance the ZT Online franchise games in a timely or effective manner; or
- any lasting or prolonged server interruption due to network failures or other factors.

For example, in the third quarter of 2009 our quarterly net online game revenues decreased by approximately 20% from the prior quarter, falling by RMB73.7 million to RMB287.5 million. The sequential decrease was mainly attributable to the Company s decision to cancel certain in-game monetization features, such as Treasure Box in ZT Online.

As with other online games, the ZT Online franchise games have finite commercial lifespans. Although our ongoing release of new version of the ZT Online franchise games helps to extend the commercial life of the games, to ensure the continued popularity of the ZT Online 1 Series and ZT Online 2, we will need to expend considerable resources to improve and update the games on a timely basis with new content and features that appeal to our players. Any decline in the popularity of the ZT Online franchise games, whether as a result of the failure to provide timely and popular updates or otherwise, would materially and adversely affect our business prospects, financial condition and results of operation.

If we are unable to successfully develop and license new popular online games, our business, financial condition and results of operations may be materially and adversely affected.

In order to maintain our long-term profitability and financial and operational success, we must continually develop or license new online games that are attractive to our players. While many new online game products are regularly introduced to the market, only a small number of hit titles account for a significant portion of total revenue in our industry. As the online game market is limited in size, successful hit product launches by our competitors may take a larger share of the market, which could cause revenues generated by our products to fall below expectations.

The success of our internally developed games will largely depend on our ability to anticipate and effectively respond to changing tastes and preferences of our players and to continually make technical advances to our platform. Developing games internally requires substantial initial investment prior to commercial launch of the games as well as a significant commitment of future resources. In addition, identifying new third party developed online games with strong market potential, and obtaining license to those online games on commercially reasonable terms, requires a significant degree of effort. If we are not able to successfully develop or license new hit online games that attract large numbers of players and result in substantial online game revenues, our business, financial condition and results of operations may be materially and adversely affected.

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We are substantially dependent upon the MMORPG segment of China s online game industry. Any decline in the size of the MMORPG market segment, due to competition from other video game products, other entertainment products or otherwise, would materially and adversely affect our results of operations.

The MMORPG segment of China s online game industry, from which we derive substantially all of our revenues, is both rapidly evolving and subject to competition from other forms of video games and other entertainment products. The future prospects for the MMORPG market segment in China will depend on a number of factors beyond our control, including:

- the growth of personal computer, internet and broadband users and their penetration in China;
- whether the MMORPG segment of China s online game industry continues to grow and the rate of any such growth;
- the availability and popularity of other forms of video game products, such as social networking games offered on Tencent s Qzone platform, mobile games offered on Apple s iOS platform, and console games playable on game consoles made by Sony, Nintendo and Microsoft;
- the availability and popularity of other forms of online and offline entertainment, such as movies, television programs and other video content;
- changes in consumer demographics and consumer tastes and preferences; and
- general economic conditions, particularly economic conditions adversely affecting discretionary consumer spending.

Although MMORPGs are currently popular in China, there is no assurance that they will continue to be popular in China or elsewhere. A decline in the popularity of online games in general, or the MMORPG market segment in particular, will materially and adversely affect our business prospects, financial condition and results of operations.

The reorganization of our game development studios could materially and adversely affect our results of operations as a portion of the profits from games developed or operated by these studios will be shared with the non controlling shareholder of these studios.

In 2008, we introduced Win@Giant, an incubation program designed to, among other things, identify, recruit and incentivize talented individuals in the areas of game design and development. In 2009 and 2010, in connection with our Win@Giant initiative, we began to reorganize our game development studios by establishing various subsidiaries that are 51% owned by us and 49% owned by the relevant development team members, by which we believe will provide greater incentive to the game development teams to make their games commercially successful. Upon completion of the studio reorganization, all of the Company s self-developed games except for the four games in the ZT Online 1 Series will be supported by studios that include key members of our development team as non controlling shareholders.

As a result of our game development studio reorganization, a portion of the net income generated by games developed or supported by these game development studios will be attributable to the non controlling shareholders of the studios. The Company consolidates its financial results with those of the reorganized studios, and then presents the net income or loss attributable to the non controlling shareholders as a separate non controlling interest line item under the heading net income or loss attributable to non controlling interests . The Company s consolidated income attributable to its shareholders is arrived at after deducting this non controlling interest. In 2011, total non controlling interest related to our reorganized studios was RMB26.4 million (US$4.2 million). If our games developed and/or supported by these studios become more popular and profitable in the future, this non controlling interest amount will increase, which may result in a lower net income attributable to Company s shareholders and may materially and adversely affect our results of operations.

There are risks that the revenue model we adopt for ZT Online 2 may not be suitable.

In connection with the introduction of ZT Online 2, we adopted a new transaction-based revenue model, which differs in material ways from the item-based revenue model that we use in connection with most of our online games. Unlike the item-based revenue model, we generally do not sell in-game virtual items directly to players in the transaction-based revenue model. Instead, the players must either earn in-game items by leveling up their in-game characters and accomplishing in-game objectives, or purchase in-game items from other players that have earned such items. We generate revenue by selling the virtual currency to players to purchase in-game items from other players. In addition, we also charge a transaction fee on each sale and purchase of an in-game item between two players.

Although ZT Online 2, which uses this new transaction-based revenue model, has experienced significant revenue growth from the start of the official implementation of the game, we cannot assure you that this new revenue model will ultimately be accepted by players and generate sustainable revenue for us. If the transaction-based revenue model is not suitable for ZT Online 2, we may need to switch to a different revenue model for the game. A change in revenue model could result in various adverse consequences, including disruptions of the game operations, criticism from game players who have invested time and money in the game and would be adversely affected by such a change, decreases in the number of our game players or decreases in the revenues we generate from the game.

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

The online game industry in China is highly competitive. In recent years, numerous competitors have entered the online game industry in China. We expect more companies to enter the online game industry in China and a wider range of online games to be introduced to the China market. Our principal competitors include China-based online game companies such as Tencent Holdings, Ltd., Changyou.com Limited, Perfect World Co., Ltd., Shanda Games Limited and NetEase.com. In addition, we expect international game developers to continue to license more of their games for operation in China.

Many of our competitors have longer operating histories, greater brand name recognition, larger international player bases and significantly greater game development, technical, financial and marketing resources than we have. Furthermore, any of our competitors may be acquired by, receive investments from or enter into other cooperative relationships with larger, more well-financed companies and therefore obtain greater financial, marketing and development and licensing resources than we have. This may allow them to devote greater resources than we can to the development and promotion of new online games and technologies similar to or better than our own. These competitors may engage in more extensive research and development, undertake more far-reaching marketing campaigns, adopt more aggressive pricing policies and make more attractive offers of employment to our existing and potential employees than we can. In addition, our international competitors may establish cooperative relationships with our local competitors, which may significantly enhance their competitiveness in the online game industry in China. New and increased competition may result in larger discounts demanded by our distributors, or price reductions in our virtual items and services, any of which could adversely affect our net revenues. In addition, the increased competition in the online game industry in China could make it difficult for us to retain and expand our existing player base, which could reduce the number of dedicated players and players with high disposable incomes that play our games and from whom we derive most of our net revenues. If we are unable to compete effectively in the online game market in China, our business, financial condition and results of operations would be materially and adversely affected.

Our operating results fluctuate from period to period, making them difficult to predict.

We have experienced significant fluctuations in our operating results from period to period due to a variety of factors, many of which are beyond our control. Significant fluctuations in our operating results could be caused by any of the following factors, among others:

- our ability to retain existing users of our games and attract new users;
- the introduction of new games or expansion packs by us or our competitors;
- changes in our game features and the corresponding impact on player behavior and purchasing patterns;
- the adoption of new, or changes in existing government regulations;
- the quality, variety, popularity and mix of virtual items and services available for purchase in our free-to-play games and related in-game promotional efforts;
- game development costs for our self-developed games, and license costs and royalty payments for licensed games;
- the amount of overseas licensing net revenues generated through our licensing arrangements with operators of our games;
- the mix of sales through our distributors (who purchase prepaid game cards at a discount to their face value) and direct sales of game points to players through our website;

- the success of our advertising and promotional efforts;
- seasonality effect during holidays in the first quarter and fourth quarter, when fewer of our targeted players play our games; and
- economic conditions in general and specifically with respect to the online game industry in China.

For example, our net revenues declined 18% in 2009, which we believe was primarily due new regulations promulgated by the PRC government in connection with certain game features, and corresponding changes to our in-game monetization features.

As a result, our operating results may vary from period to period, would be difficult to predict for any given period, may be adversely affected from period to period and may not be indicative of our future performance. In the event that our operating results do not meet our expectations or those of the public market analysts and investors, the price of our ADSs may decline.

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We may not be able to successfully implement our growth strategies, which would materially and adversely affect our revenue, profitability and competitiveness.

We are pursuing a number of growth strategies, including expanding our ZT Online franchise, reorganizing our game development studios to incentivize our key developers, acquiring additional licenses to operate third party developed games in China and pursuing additional licensing opportunities for operating our games overseas, and expanding into non-MMORPG market segments by developing web games, and games for operating on mobile and tablet platforms.

For example, we have reorganized our game development studios by establishing various subsidiaries that are generally 51% owned by us and 49% owned by the relevant key development team members based on our Win@Giant incubation initiative, with an aim to facilitate our development of new online games. Each reorganized studio only focuses upon producing and supporting their own internally developed games, which we believe will provide the game developers greater incentive to make their games commercially successful. Pursuant to such reorganization arrangement, Giant Online, one of our existing MMORPGs, is supported by Shanghai Juhuo Network Technology Co., Ltd., or Juhuo Network, and ZT Online 2 is supported by Shanghai Jujia Network Technology Co., Ltd., or Jujia Network. For additional information regarding the reorganization of our game development studios, see Item 4. Business Overview Game Development and Sourcing Game Development.

In addition, we have established an internal development team focusing on producing web games, which are online games that do not require installation of client side server software, thereby reducing the time required for players to begin playing the games. We are also exploring development of games to be operated on mobile and tablet devices.

Our experience with our various new growth strategies is limited. Accordingly, we cannot assure you whether all or any of these strategies will be successful. If we are unable to implement our growth strategies, our revenue and profitability may not grow as we expect, and our competitiveness may be materially and adversely affected.

We may not sustain our historical growth rate or profitability

We have experienced significant revenue growth in a relatively short period of time. After commercially launching our first game in January 2006, net revenues increased from RMB408.5 million in 2006 to RMB1,527.5 million in 2007 and to RMB1,594.7 million in 2008, representing a 273.9% increase in 2007 and an 4.4% increase in 2008. However, our net revenues decreased by 18.2% to RMB1,303.8 million in 2009 and maintained relatively stable in 2010 and 2011. Although we believe the decrease of our net revenues in 2009 was largely due to new regulations on certain game features promulgated by the PRC government and a change of our in-game monetization features, we may not sustain our historical levels of revenue growth in future periods due to a number of different factors, including, among others, economic factors out of our control, competitiveness in the online game industry, in which market share can be quickly acquired or lost, the greater difficulty of growing at sustained rates from a larger net revenue base, the need to increase our research and product development expenses in order to develop new and successful games, the potential need to expend greater amounts in order to license or acquire new games, and our inability to prevent our other costs and operating expenses from increasing. Accordingly, you should not rely on the results of any prior period as an indication of our future operating performance.

Our business may be materially harmed if our games are not featured in a sufficient number of internet cafés in China.

A substantial number of players access our game through internet cafés. Due to limited storage space on their computer hard drives for client side game software, internet cafés generally only feature a select number of games on their computers. We thus compete with a growing number of other online game operators to ensure that our games are featured on these computers. This competition may intensify in China due to a nationwide suspension of approval for the establishment of new internet cafés since 2007. After the suspension of approving new internet cafés in 2007, the total number of internet cafés in the PRC was limited and controlled by relevant authorities. Governmental authorities may from time to time impose even stricter requirements, such as customer age limit and hours of operation for internet cafés, in response to certain media report on gang fights, arson and other incidents that may relate to internet cafés. We have taken steps to ensure that our games are featured in a sufficient number of internet cafés, such as maintaining good relationships with internet café administrators, requiring our distributors to maintain a sales presence in a wide range of internet cafés and through general sales and marketing efforts. If we fail to maintain good relationships with internet café administrators, or if we and/or our distributors fail to successfully persuade internet cafés to feature our online games on their computers, our business, financial condition and operating results may be materially and adversely affected.

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

Although the use of personal computers in China has increased in recent years, the penetration rate for personal computers in China is much lower than in the United States. In addition, despite a decrease in the cost of internet access in China due to a decrease in the cost of personal computers and the introduction and expansion of broadband access, the cost of personal internet access remains relatively high in comparison to the average per capita income in China. The PRC government has also promulgated a number of regulations to curb the growth of internet cafés. The limited use of personal computers in China, the relatively high cost of personal internet access and increased restrictions on internet cafés may limit the growth of our business. Furthermore, any internet access or telecommunications fee increase could reduce the number of players that play our online games and materially and adversely affect our business, financial condition and results of operations.

We rely on our nationwide distribution network for a significant portion of our net revenues. Failure to maintain good relationships with our distributors, or failure of our distributors to comply with the terms of our distribution agreements, could materially disrupt our business and harm our net revenues.

Online payment systems in China are still in a relatively early stage of development and are not as widely used by customers in China as in the United States. As a result, although we make our game points available for online purchase through our official game website, our business is dependent on the performance of our regional distributors, who are composed of independent third parties. In 2011, 75.2% of our sales proceeds were generated through sales of prepaid game cards to our distributors. Our largest distributor accounted for 4.5% of our sales proceeds in 2011. Maintaining relationships with existing distributors may be difficult and time-consuming. Although we typically enter into annual contracts with our distributors, our distribution agreements are not exclusive and do not prohibit our distributors from selling our competitors game cards. Failure to maintain good relationships with our distributors could restrict our sales channels or encourage our distributors to seek to distribute our competitors products, each of which could materially and adversely disrupt our business and harm our net revenues.

In addition, our distributors and internet cafés and other outlets in which they sell our prepaid game cards may violate our distribution agreements. Examples of violations include:

- failure to meet minimum sales targets or penetration targets, or failure to maintain minimum price levels for our prepaid game cards;
- failure to properly promote our online games in local internet cafés and other important outlets, or failure to cooperate with our sales and marketing team s efforts in their designated territories; and
- selling our prepaid game cards outside their designated territories, possibly in violation of the exclusive distribution rights that we have granted to other distributors.

Some of our distributors have committed these types of violations in the past, which resulted in our terminating of their existing distribution agreements. If we decide to fine, suspend or terminate our distributors for acting in violation of our distribution agreements, or if the distributors fail to address material violations committed by any of their retail outlets, our ability to effectively sell our prepaid game cards in any given territory could be negatively impacted. We may also be liable in China for legal or regulatory violations by any of our distributors.

We could be liable for breaches of security of our website and third-party online payment system, which may have a material adverse effect on our reputation and business.

In 2011, 24.8% of our sales proceeds were generated by players purchasing our game points directly through our official game website, and the remaining 75.2% from purchasing physical or virtual game cards through our distributors. The direct game point purchasing through our official game website is processed by a variety of third-party online payment service providers, including Alipay.com Co., Ltd, Shanghai China UnionPay E-Payment Service Co., Ltd, 99Bill Corporation, China Payment and Remittance Service Co., Ltd. and several major commercial banks. In such transactions, secure transmission of our players confidential billing information over public networks, including our official game website, is essential for maintaining consumer confidence. We currently provide password protection for all of our player accounts. In addition to the general password protection, we also sell a dynamic password generator, which can be used for multiple accounts under a player s name, to better ensure the security of our players accounts. While we have not experienced any breach of our security measures to date, current security measures may be inadequate. We must therefore be prepared to increase our security measures and efforts so that our customers have confidence in the reliability of the online payment systems we use.

In addition, we do not have control over the security measures of our third-party online payment service providers, and those security measures may not be adequate at present or may not be adequate with the expected increased usage of online payment systems. We could be exposed to litigation and possible liability if we fail to secure confidential customer information, which could harm our reputation, ability to attract customers and ability to encourage players to purchase our game points.

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

Any failure to maintain satisfactory performance, reliability, security and availability of our network infrastructure, including issues arising from the internet infrastructure in China, security breaches caused by hacking and transmission of computer viruses, and natural disasters such as floods and earthquakes, may cause significant harm to our reputation and our ability to retain existing and attract new game players. In addition, all of the game servers operating our games, and all of the servers handling log-in, billing and data back-up matters for us are hosted and maintained by third-party service providers. Major risks involved in such network infrastructure include any break-downs or system failures resulting in a sustained shutdown of all or a material portion of our servers, including failures which may be attributable to sustained power shutdowns, or efforts to gain unauthorized access to our systems causing loss or corruption of data or malfunctions of software or hardware.

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

Changes in our estimates of the virtual items sold within our games may have a negative impact on our net revenue and results of operations.

We generally recognize revenues from virtual items sold to players of our free-to-play online games over the estimated lifespan of the relevant virtual items as determined by historical player usage patterns and playing behavior. We continuously monitor the useful life of each type of virtual item we sell and make adjustments as appropriate. Any such adjustment may cause our revenues to be recognized over a significantly different time period, which may have a negative impact on our net revenue and results of operations.

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

Our online games may contain undetected programming errors or other defects. In addition, parties unrelated to us have in the past, and may again in the future, develop internet cheating programs that enable our users to acquire superior features for their game characters for which they would otherwise be required to pay or otherwise earn through game play. In addition, certain cheating programs could cause the loss of a character s superior features acquired by a player. The occurrence of undetected errors or defects in our games, and our failure to discover and disable cheating programs affecting the fairness of our game environment, could damage our reputation and result in a decline in our active paying users. This could materially and adversely affect our business, financial condition and results of operations.

We depend on our key personnel, and our business and growth prospects may be severely disrupted if we lose their services or are unable to attract new key employees.

Our future success is heavily dependent upon the continued service of our key executive officers and other key employees. In particular, we rely on the expertise, experience and leadership of Yuzhu Shi, our founder, chairman and chief executive officer, and Ms. Wei Liu, our president, in connection with our business operations and game development. We also rely on their personal relationships with our employees, the relevant regulatory authorities, and our distributors. In addition, we are dependent on a number of key technology officers and staff for the development and operation of our online games. Furthermore, we need to continue to attract and retain skilled and experienced online game development personnel to maintain our competitiveness.

If one or more of our key personnel are unable or unwilling to continue in their present positions, we may not be able to replace them easily or at all and may incur additional expenses to recruit and train new personnel. These difficulties may disrupt our business, and our financial condition and results of operations could be materially and adversely affected. We do not maintain key-person life insurance for any of our key personnel. In addition, if any of our executive officers or key employees joins a competitor or forms a competing company, we may lose know-how, trade secrets, suppliers and key professionals and staff. All of our employees, including each of our executive officers and key employees, have entered into an employment agreement with us, which contains customary non-compete provisions. Although non-compete provisions are generally enforceable under PRC laws, PRC legal practice regarding the enforceability of such provisions may not be as well-developed, and therefore we cannot assure you that a PRC court would enforce such provisions. Furthermore, since the demand and competition for talent is intense in our industry, particularly for online game development personnel and related technical personnel, we may need to offer higher compensation and other benefits in order to attract and retain key personnel in the future, which could increase our compensation expenses. In the fourth quarter of 2008, we introduced Win@Giant, an incubation program designed to attract and retain talented employees, developers and business partners. Under Win@Giant, we have reorganized our game development studios by establishing various subsidiaries that are generally 51% owned by us and 49% owned by the relevant key development team members, with an aim to facilitate our development of new online games. Each reorganized studio only focuses on producing and supporting internally developed games, which we believe will give them greater incentive to make their games commercially successful.

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While this program is intended to supplement and not to replace our normal hiring efforts, we cannot assure you that this program will be successful or that we will be able to attract or retain qualified game developers or other key personnel that we will need to achieve our business objectives.

Future acquisitions may have an adverse effect on our ability to manage our business.

We may expand our business through selective acquisitions in the future. We do not, however, have significant experience in completing acquisitions or integrating new companies into our existing operations. In the event that we pursue acquisition opportunities in the future, we will face a number of risks that could materially and adversely affect our business and results of operations, including overpaying for the acquisitions, an inability to realize the synergies contemplated at the time of executing the transactions, difficulties in integrating the acquired companies, the diversion of management resources from other strategic and operational issues, the inability to retain the key employees of the acquired companies, and unknown and unforeseen assumed liabilities. For example, in 2010 we acquired the entire equity interest in Beijing Julun Network Technology Co., Ltd., or Julun Network, an online game developer, and a controlling equity interest in Hangzhou Snow Wolf Software Co. Ltd., or Snow Wolf Software, a Hangzhou based game development studio. In 2011, we acquired the remaining 49% equity interest of Shanghai Juyan Network Technology Co., Ltd., or Juyan Network, at a consideration of RMB3.5 million (US$0.56 million) which result in Juyan Network becoming a wholly-owned subsidiary of Shanghai Zhengduo Information Technology Co., Ltd., or Zhengduo Information. Subsequent to the acquisition related to Julun Network, Julun Network recorded losses in 2010 and 2011. If we fail to properly address these risks associated with any future acquisitions, our business, results of operations and financial condition may be materially and adversely affected.

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

We regard our copyrights, trademarks, trade secrets and other intellectual property as critical to our success. Unauthorized use of the intellectual property that we have may adversely affect our business and reputation.

We have historically relied on a combination of trademark and copyright law, trade secret protection, internal security measures and restrictions on disclosure to protect our intellectual property rights. Although we presently enter into confidentiality and invention assignment agreements with most of our employees, we cannot assure you that these confidentiality agreements will not be breached, that we will have adequate remedies for any breach, or that our proprietary technology will not otherwise become known to, or be independently developed by, third parties.

As of December 31, 2011, we own a total of 479 registered trademarks in China and overseas and are in the process of applying for the registration of 213 trademarks in China and 40 trademarks overseas. We cannot assure you that any of these trademark applications will ultimately be successful or will provide adequate protection for our business. Some of our pending applications or registrations may also be successfully challenged or invalidated by others. If our trademark applications or registrations are not successful, we may have to use different marks or otherwise enter into arrangements with third parties.

In addition, China s online game market often faces challenges from pirate servers, which are game servers operating unauthorized copies of online games that enable players to play those games without purchasing prepaid game cards or game points from the authorized operators. We mitigate the risk of pirate servers by maintaining stringent security controls over our server side software at our offices and insisting upon high security standards at the various internet data centers where our servers are housed. In addition, once pirate servers are identified, we will promptly work with local government authorities to shut the servers down. If pirate game servers continue to operate any of our games, our business, financial condition and results of operations may be materially and adversely affected.

Implementation of intellectual property laws in China has historically been lacking, primarily because of difficulties in enforcement. Accordingly, intellectual property right protection in China may not be as effective as in the United States or other developed countries. Policing unauthorized use of our proprietary technology, trademarks and other intellectual property is difficult and expensive, and litigation may be necessary in the future to enforce our intellectual property rights. Future litigation could result in substantial costs and diversion of our resources, and could disrupt our business, as well as have a material adverse effect on our financial condition and results of operations.

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We may be subject to infringement and misappropriation claims in the future, which may cause us to incur significant expenses, pay substantial damages and be prevented from providing our services or technologies.

Our success depends, in part, on our ability to carry out our business without infringing the intellectual property rights of third parties. We may be subject to litigation involving claims of patent, copyright or trademark infringement, or other violations of intellectual property rights of third parties. In particular, the patent field covering online games and related technology is rapidly evolving and surrounded by a great deal of uncertainty, and we cannot assure you that our technologies, processes or methods would not be covered by third-party patents, either now existing or to be issued in the future. Future litigation may cause us to incur significant expenses, and third-party claims, if successfully asserted against us, may cause us to pay substantial damages, seek licenses from third parties, pay ongoing royalties, redesign our services or technologies, or prevent us from providing services or technologies subject to these claims. Even if we were to prevail, any litigation would likely be costly and time-consuming and divert the attention of our management and key personnel from our business operations.

We have no general business insurance coverage, which may result in our incurring substantial costs and the diversion of resources.

Insurance companies in China offer limited business insurance products and do not, to our knowledge, offer business liability insurance. While business interruption insurance is available to a limited extent in China, we have determined that the risks of disruption, cost of such insurance and the difficulties associated with acquiring such insurance on commercially reasonable terms make it impractical for us to subscribe for such insurance. As a result, we do not have any business liability, disruption or litigation insurance coverage for our operations in China. Except for legally required automobile liability insurance and property insurance for our offices on Yishan Road, Guilin Road and Songjiang district in Shanghai, we also do not carry any other property or casualty insurance. Any business disruption or litigation, or any liability or damage to, or caused by, our facilities or our personnel may result in our incurring substantial costs and the diversion of resources.

We may be unable to maintain an effective system of internal control over financial reporting, and as a result we may be unable to accurately report our financial results or prevent fraud.

We are subject to provisions of the Sarbanes-Oxley Act of 2002. Section 404 of the Sarbanes-Oxley Act requires that we include a report from management on the effectiveness of our internal control over financial reporting in our annual reports on Form 20-F. In addition, our independent registered public accounting firm must attest to and report on the operating effectiveness of our internal control over financial reporting. While our management concluded that our internal control over financial reporting is effective as of December 31, 2011, and our independent registered public accounting firm concurred our management s conclusion, our management may conclude in the future that our internal controls are not effective. Our independent public accounting firm s failure to conclude that our internal control over financial reporting is effective could result in a loss of investor confidence in the reliability of our reporting processes, which could materially and adversely affect the trading price of our ADSs.

We are an online game company, and therefore our experience with investment activities is limited.

We explore selected investment opportunities that may have strategic value to us or that are purely financial in nature, with the primary objective of providing us with a more favorable rate of return than that customary of ordinary bank deposits.

For example, as of December 31, 2010 and 2011, we had certain short-term and long-term held-to-maturity investments, amounting to RMB1,850.0 million and RMB700.0 million (US$111.2 million), respectively. In order to derive higher investment returns for the Company, we invested RMB100.0 million (US$15.9 million) in a trust arrangement with China Resources SZITIC Trust Co., Ltd. in May 2011 who in turn invested in certain real estate development projects in Ningbo and Chengdu. Similarly, in November 2011, we entered into a trust arrangement with China Railway Trust Co., Ltd., an affiliate of state owned China Railway Group Limited, to invest RMB 600.0 million, (US$95.3 million), which was used to fund a short-term loan provided to Zhonghang Wanke Co., Ltd. (Zhonghang Wanke), a large commercial and residential real estate development company located in the P.R.C. Although our held-to-maturity investment contracts are secured or wholly guaranteed by a reputable financial institution, a credit-worthy company, or by the properties of the underlying investment projects, any default by the trust companies or the borrowers under these trust arrangements, or any deterioration in the financial condition of the secured collateral or these financial institution or project companies could cause significant loss to us and have a material adverse effect on our financial condition and results of operations.

In addition, we have made certain equity investments. In April 2011, we committed to investing RMB30.0 million (US$4.8 million) in Beijing Innovation Work Investment Center (LP), an early-stage internet and technology company investment fund operating throughout China, which is led by Mr. Kai-Fu Lee. Out of the RMB30.0 million commitment, RMB9.0 million had been invested by the end of 2011. In September 2011, we invested RMB317,050,000 (US$50,374,172) in the Yunfeng e-Commerce Funds (the Yunfeng Fund) for the purpose of purchasing shares of the Alibaba Group Holding Limited (the Alibaba Group), China s leading e-commerce company, that became available as part of the employee liquidity program offered by Alibaba Group to its employees. The Yunfeng Fund has a term of ten years, which may be extended for additional successive one-year periods up to a maximum of two years, and may be further extended upon the written election or vote of a majority in interest of the limited partners. The Yunfeng Fund purchased ordinary shares of the Alibaba Group at a price per share of US$13.50. The Company s interests in the Alibaba Group are held indirectly through its partnership interests in the Yunfeng Fund and subject to transfer restrictions, including a lockup period until December 31, 2012. If (i) the Company transfers its partnership interest in the Yunfeng Fund; (ii) the Yunfeng Fund sells its shares of the Alibaba Group; or (iii) the Alibaba Group makes an initial public offering of its shares, in each case, at a price per share of the Alibaba Group that is significantly less than the price per share paid by the Yunfeng Fund, the Company could recognize a significant loss and its financial condition and results of operations could be materially and adversely affected.

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These investments are made in contemplation that the underlying businesses obtain and/or sustain continued business growth, eventually go public or be acquired, which there are no guarantees of occurring, if at all. In addition, some of these equity investments may only provide limited exits to us and therefore our investments may be illiquid until their respective maturity, or potentially until a liquidity event occurs with respect to the underlying companies that we hold indirect interest in.

Although these equity investments may offer us potentially higher returns, these returns are not guaranteed and as such, we may not be able to achieve an adequate rate of return and may suffer losses on our investments. If we experience significant losses in connection with our investment activities, our financial condition and results of operations may be materially and adversely affected.

We face risks associated with the licensing of our games overseas, and if we are unable to effectively manage these risks, they could impair our ability to expand our business internationally.

We have licensed seven of our self-developed games for operation in various countries, regions and territories of Asia, Europe and North America by a variety of different operating partners. In 2011, our revenues from licensing our games to third party operators was approximate RMB54.5 million (US$8.7 million), accounting for approximately 3.0% of our total net revenues. Licensing our games for operation in overseas markets exposes us to a number of risks, including difficulties in:

- identifying and maintaining good relations with game operators who are knowledgeable, and can effectively distribute and operate our games, in overseas markets;
- negotiating licensing agreements with game operators on terms that are commercially acceptable to us and enforcing the provisions of those agreements;
- developing games, updates and expansion packs catering to overseas markets and renewing our license agreements with game operators upon expiration;
- maintaining the reputation of our company and our games, given that our games are operated by game operators in the international markets with different standards;
- protecting our intellectual property rights overseas and managing the related costs;
- receiving and auditing the royalties we are entitled to receive;
- complying with the different commercial and legal requirements of the international markets in which our games are offered, such as game import regulatory procedures, taxes and other restrictions and expenses; and
- managing our foreign currency risks.

If we are unable to manage these risks effectively, our ability to license our games overseas may be impaired, which may materially and adversely affect our business, financial conditions and results of operations would be materially and adversely affected.

Risks Related to the Regulation of Our Business

PRC regulations relating to our industry are evolving. Any adverse or unanticipated regulatory changes could significantly harm our business or limit our ability to operate.

Substantial uncertainties and restrictions exist with respect to the application and implementation of PRC laws and regulations in the online game industry. If the PRC government finds that our past or current structure for our business operations does not comply with PRC laws and regulations, we may lose control of Giant Network, resulting in its deconsolidation, and could be subject to severe penalties, including shutting down of our operations.

Various regulations in China currently restrict or prevent foreign and foreign-invested entities from engaging in operating online games in China. Since we are a Cayman Islands exempted company and therefore are a foreign or foreign-invested enterprise under PRC law, neither we nor our PRC subsidiary are eligible to hold a license to operate online games in China. To comply with PRC laws and regulations, we operate our online games in China through a series of contractual arrangements entered into between our wholly owned PRC subsidiary, Shanghai Zhengtu Information Technology Co., Ltd, or Zhengtu Information, and Shanghai Giant Network Technology Co., Ltd, or Giant Network, which is beneficially owned by certain of our officers and directors and other individuals, all of whom are PRC citizens. Giant Network holds a value-added telecommunications business operating license, or ICP license, issued by the Shanghai Communications Administration, a local office of the Ministry of Industry and Information Technology of the PRC, or the MIIT, which allows Giant Network to provide internet content distribution services in Shanghai. This license is essential to the operation of our business.

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Despite the lack of technical majority ownership, there exists a parent-subsidiary relationship between our Cayman Islands Company and Giant Network through the irrevocable proxy agreement, whereby equity holders of Giant Network effectively assigned all of their voting rights underlying their equity interest to our Cayman Islands Company. We have entered into contractual arrangements with Giant Network pursuant to which Zhengtu Information, our wholly owned subsidiary, provides technical support and an exclusive software license to Giant Network. As a result of these contractual arrangements, under U.S. GAAP, we are also considered the primary beneficiary of Giant Network and, accordingly, we consolidate its historical results in our financial statements. For detailed descriptions of these contractual arrangements, see Item 4. Information on the Company Organizational Structure and Item 7. Major Shareholders and Related Party Transactions Related Party Transactions.

The relevant PRC regulatory authorities have broad discretion in determining whether a particular contractual structure is in violation of the law. For example, on July 26, 2006, the MIIT publicly released the Notice on Strengthening the Administration of Foreign Investment in Operating Value-added Telecommunications Business, dated July 13, 2006, or the MIIT Notice, which reiterates certain provisions under China s Administrative Rules on Telecommunications Enterprises prohibiting a domestic company that holds an ICP license from renting, transferring or selling a telecommunications license to foreign investors in any form, or providing any resources, sites or facilities to foreign investors that intend to conduct value-added telecommunication business illegally in China. There is currently no official interpretation or implementation practice under the MIIT Notice. Due to a lack of interpretative materials from the authorities, it is uncertain whether the MIIT would consider our corporate structure and the contractual arrangements as a kind of foreign investment in telecommunication services. Therefore, it is unclear what impact the MIIT Notice might have on us or the other Chinese internet companies that have adopted the same or similar corporate structures and contractual arrangements as ours.

In addition, on September 28, 2009, GAPP, together with the National Copyright Administration, and the National Office of Combating Pornography and Illegal Publications jointly issued a Notice on Further Strengthening on the Administration of Pre-examination and Approval of Online Games and the Examination and Approval of Imported Online Game (Xin Chu Lian [2009] No. 13), or the GAPP Notice. The GAPP Notice restates that foreign investors are not permitted to invest in online game-operating businesses in China via wholly owned, equity joint venture or cooperative joint venture investments and expressly prohibits foreign investors from gaining control over or participating in domestic online game operators through indirect ways such as establishing other joint venture companies, or contractual or technical arrangements. However, the GAPP Notice does not provide any interpretation of the term foreign investors or makes a distinction between foreign online game companies and companies under a similar corporate structure like ours, including those listed Chinese internet companies that focus on online game operation. Thus, it is unclear whether GAPP will deem our corporate structure and operations to be in violation of these provisions.

Furthermore, as certain other government authorities such as the Ministry of Commerce, or MOFCOM, the Ministry of Culture, or the MOC, and the MIIT did not join GAPP in issuing the GAPP Notice, the views of these authorities are uncertain in clarifying the scope of implementation and enforcement of the GAPP Notice.

We cannot be sure that the PRC government would view our contractual arrangements to be in compliance with PRC licensing, registration or other regulatory requirements, including without limitation, the requirements described in the MIIT Notice and the GAPP Notice, existing policies, or with requirements or policies that may be adopted in the future. If any of our businesses is determined not to be in compliance with the MIIT Notice or the GAPP Notice, the PRC government could take a number of regulatory or enforcement actions that could be harmful to our business, including but not limited to: levying fines, revoking our business and operating licenses, discontinuing or restricting our operations, blocking our website, requiring us to restructure our business or imposing additional conditions or requirements that we cannot comply with. We may also encounter difficulties in obtaining performance or enforcement of related contracts, thereby losing our control of Giant Network, resulting in its deconsolidation. Any of these actions could cause our business, financial condition and results of operations to suffer and subsequently the market price of our ADSs to decline.

The contractual arrangements with our affiliated Chinese entity and its shareholders, which relate to critical aspects of our operations, may not be as effective in providing operational control as direct ownership. In addition, these arrangements may be difficult and costly to enforce under PRC law.

We rely on contractual arrangements with Giant Network and its shareholders in China to operate our business. For a description of these contractual arrangements, see Item 4. Information on the Company Organizational Structure and Item 7, Major Shareholders and Related Party Transactions Related Party Transactions. These contractual arrangements may not be as effective as direct ownership in providing us control over Giant Network. Direct ownership would allow us, for example, to directly or indirectly exercise our rights as a shareholder to (i) effect changes in the board of directors of Giant Network, which, in turn, could effect changes, subject to any applicable fiduciary obligations, at the management level, and (ii) derive economic benefits from the operations of Giant Network by causing it to declare and pay dividends. Because we rely on these contractual arrangements to effect control and management of Giant Network, we are exposed to the risk that the shareholders of Giant Network may fail to perform his or her respective obligations under these contractual arrangements. In addition, the shareholders of Giant Network may potentially have a conflict of interest with us, and they may breach their contracts with us or cause such contracts to be amended in a manner contrary to the interest of our company, if they believe such action furthers their own interest, or if they otherwise act in bad faith. If any of the foregoing were to occur, we may have to incur substantial costs and expend significant resources to enforce these contractual arrangements.

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In addition, all of these contractual arrangements are governed by PRC laws and provide for the resolution of disputes through arbitration in the PRC. Accordingly, these contracts would be interpreted in accordance with PRC laws and any disputes would be resolved in accordance with PRC legal procedures. The legal environment in the PRC is not as developed as in other jurisdictions, such as the United States. As a result, uncertainties in the PRC legal system could limit our ability to enforce these contractual arrangements. In the event we are unable to enforce these contractual arrangements, which relate to critical aspects of our operations, we may be unable to exert effective control over Giant Network and our ability to conduct our business may be negatively affected.

The contractual arrangements entered into among our PRC subsidiary, our affiliated entity and its shareholders may be subject to audit or challenge by the PRC tax authorities; a finding that our PRC subsidiary or our affiliated entity owes additional taxes could substantially reduce our net income and the value of your investment.

Under PRC laws and regulations, arrangements and transactions among related parties may be subject to audit or challenge by the PRC tax authorities. We could face material and adverse tax consequences if the PRC tax authorities determine that the contractual arrangements among our PRC subsidiaries Zhengtu Information and Zhengju Information, our affiliated entity Giant Network, Giant Network s shareholders and our reorganized game development studios do not represent arm s-length prices and adjust any of their income in the form of a transfer pricing adjustment. A transfer pricing adjustment could, among other things, result in, for PRC tax purposes, a reduction of expense deductions recorded by Giant Network, which could in turn increase our tax liabilities. In addition, the PRC tax authorities may impose late payment fees and other penalties on Zhengtu Information or Giant Network for underpayment of taxes.

The discontinuation, reduction or delay of any of the preferential tax treatments or the government financial incentives currently available to us in the PRC could materially and adversely affect our business, financial condition and results of operations.

Under PRC Enterprise Income Tax Law effective on January 1, 2008, or New EIT Law, foreign invested companies such as Zhengtu Information, and domestic companies such as Giant Network, are subject to a unified income tax rate of 25%. Various favorable income tax rates are, however, available for qualified enterprises in encouraged sectors of the economy. Companies that qualify as a high and new technology enterprise, or HNTE, a status which is reassessed every three years, are subject to an income tax rate of 15%. In addition, companies that qualify as a software development enterprise are exempt from income tax for two years and subject to an income tax rate of 12.5% for the following three years.

In 2008, the Shanghai government granted Zhengtu Information HNTE status, which was successfully renewed in 2011. In 2011, the Shanghai government recognized our three PRC subsidiaries as software development enterprises, including Shanghai Jujia Network Technology Co. Ltd., or Jujia Network, and Shanghai Juhuo Network Technology Co. Ltd., or Juhuo Network, two of our 51% owned game development studios and Shanghai Zhengju Information Technology Co., Ltd., or Zhengju Information, wholly owned by Shanghai Zhengduo Information Technology Co., Ltd., or Zhengduo Information. In addition, Wuxi Giant Network Technology Co., Ltd., or Wuxi Network also received certificates for software development enterprises in 2011.

We cannot assure you, however, that our PRC companies will be able to continue to qualify for preferential tax treatment. If any of our PRC companies that qualified for preferential tax treatments fails to continue to qualify in a subsequent year, our income tax expenses would increase, which may have a material adverse effect on our net income and results of operations. For additional information regarding the preferential tax treatments of our various PRC companies, see Item 5. Operating and Financial Review and Prospects Operating Results Income Tax Expense China.

In addition, in 2009, 2010 and 2011, our PRC companies received financial incentives from the government in an aggregate amount of RMB88.5 million, RMB57.4 million and RMB47.7 million (US$7.6 million), respectively, which were calculated with reference to taxable revenues and taxable income. To be eligible for the government financial incentives, we are required to continue to meet a number of financial and non-financial criteria and, even if we meet these criteria, the grant of any incentive is still subject to the discretion of the municipal government. Moreover, the central government or municipal government could at any time eliminate or reduce these government financial incentives. Since the government has discretion in the timing of payment and the amount of the financial incentive, we cannot assure you that we will be able to continue to enjoy these government financial incentives or receive such incentives promptly. The discontinuation, reduction or delay of these government financial incentives could have a material adverse effect on our business, financial condition and results of operations.

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We may be classified as a resident enterprise under the PRC New EIT Law; such classification could result in unfavorable tax consequences to us and our non-PRC shareholders.

The New EIT Law provides that enterprises established outside of China whose de facto management bodies are located in China are considered resident enterprises and are generally subject to the uniform 25% enterprise income tax rate on their worldwide income. In addition, a circular issued by the State Administration of Taxation regarding the standards used to classify certain Chinese enterprise controlled companies established outside of China as resident enterprises , or Circular 82, clarified that dividends and other income paid by such resident enterprises will be considered to be PRC sourced income, subject to PRC enterprise income tax, currently at a rate of 10%, when recognized by non-PRC shareholders. This circular also subjects such resident enterprises to various reporting requirements with the PRC tax authorities. Under the implementation regulations to the New EIT Law, a de facto management body is defined as a body that has material and overall management and control over the manufacturing and business operations, personnel and human resources, finances and treasury, and acquisition and disposition of properties and other assets of an enterprise. In addition, Circular 82 details that certain Chinese-controlled enterprises will be classified as resident enterprises if the following are located or resident in China: (i) senior management personnel and departments that are responsible for daily production, operation and management; (ii) financial and personnel decision making bodies; (iii) key properties, accounting books, company seal, and minutes of board meetings and shareholders meetings; and (iv) half or more of the directors or senior management having voting rights.

Although the determining criteria set forth in Circular 82 may reflect the State Administration of Taxation s general position on how the de facto management body test should be applied in determining the tax resident status of offshore enterprises, Circular 82 only applies to offshore enterprises controlled by PRC enterprises or PRC enterprise groups, not those controlled by individuals or foreign enterprises like us. Therefore, we do not currently consider our company or any of our overseas subsidiaries to be a PRC resident enterprise. However, if the PRC tax authorities determine that our Cayman Islands holding company is a resident enterprise, a number of unfavorable PRC tax consequences could follow. First, we may be subject to enterprise income tax at the rate of 25% on our worldwide income, as well as PRC enterprise income tax reporting obligations. Second, although under the New EIT Law and the Implementing Rules, dividends paid to our non-PRC holding companies from our PRC subsidiaries would qualify as tax-exempted income , any such dividends paid to our non-PRC holding companies may be subject to an enterprise income tax and the PRC foreign exchange control 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. Finally, dividends paid by us to our non-PRC shareholders and capital gains recognized by them with respect to the sale of our stock may be treated as income derived from sources within the PRC and as a result may be subject to a PRC income tax. Such determination could have a material adverse effect on our net income and results of operations, and may require us to withhold tax on our non-PRC shareholders. We are actively monitoring the resident enterprise classification rules and our Cayman Islands holding company s facts and circumstances relative to the classification rules. Similar results could follow if our BVI subsidiary is considered a PRC resident enterprise.

The PRC New EIT Law will affect tax exemptions on the dividends we receive and we may not able to obtain certain treaty benefits on such dividends.

We are a holding company incorporated under the laws of the Cayman Islands. We conduct substantially all of our business through our PRC subsidiaries and affiliated entities from which we derive all of our income from these subsidiaries. Prior to January 1, 2008, dividends derived by foreign enterprises from business operations in China were not subject to the PRC enterprise income tax. However, such tax exemption ceased after January 1, 2008 with the effectiveness of the New EIT Law and a withholding tax rate of 10% will apply on such dividends (subject to reductions by the relevant tax treaties, if applicable).

According to the Notice of the State Administration of Taxation on Summary Table of Treaty Rates for Dividends, or Circular 112, which was issued on January 29, 2008 and the Arrangement between the PRC and the Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Tax Evasion, or the Double Taxation Arrangement (Hong Kong), which became effective on December 8, 2006, dividends from our PRC subsidiaries paid to us through our Hong Kong subsidiary may be subject to a withholding tax at a reduced rate of 5% if such Hong Kong entity owns at least 25% of the equity interest of the PRC company. The ultimate withholding tax rate will be determined by treaty between the PRC and the tax residence of the holder of the PRC subsidiary. The State Administration of Taxation promulgated a tax notice on October 27, 2009, or Circular 601, which provides that tax treaty benefits will be denied to conduit or shell companies without business substance and a beneficial ownership analysis will be used based on a substance-over-the-form principle to determine whether or not to grant treaty benefits. It is unclear at this early stage whether Circular 601 applies to dividends from our PRC subsidiaries paid to us through our Hong Kong subsidiary. However, the issuance of Circular 601 shows that there can be no assurance that the Double Taxation Arrangement between China and Hong Kong could be successfully applied as noted above. If our Hong Kong subsidiary cannot be regarded as the beneficial owner of such dividends, it will not be entitled to the treaty benefits under the Double Taxation Arrangement (Hong Kong) and thus the dividends will be subject to normal withholding tax of 10% as provided by the PRC New EIT Law.

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The recently adopted PRC tax reform pilot program, which was initiated in Shanghai and may be extended to other cities in the future, requires us to pay value added tax instead of business tax in Shanghai and it could result in unfavorable tax consequences to us.

The PRC government recently adopted a PRC tax reform pilot program, which was initiated in Shanghai and may be extended to other cities in the future. On November 16, 2011, the Ministry of Finance and the State Administration of Taxation jointly issued the Circular on the Pilot Program for the Collection of Value Added Tax Instead of Business Tax, or Circular 110, and the Circular on the Pilot Program for the Collection of Value Added Tax Instead of Business Tax in Transportation and Certain Modern Service Sectors in Shanghai, or the Circular 111, to provide specific implementation rules for the pilot program, which became effective January 1, 2012. Pursuant to Circular 110 and Circular 111, starting from January 1, 2012, companies which are classified by Shanghai s local tax authorities in transportation and certain modern service sectors in Shanghai are required to pay a Value Added Tax, or VAT, instead of the business tax. Specifically, a 17% rate applies to the movable property leasing services, an 11% rate applies to the transportation services and a 6% rate applies to certain other modern services, such as research and development, technological services, culture, logistics and consultation. This tax reform pilot program is new and its interpretation and enforcement involve significant uncertainties. In the event that our other PRC subsidiaries located in Shanghai engage in business falling within the category of certain modern service sectors, or if we are unable to obtain sufficient amount of qualified VAT invoices from our suppliers to offset the net revenue subject to such VAT, our PRC subsidiaries, which pay business tax at a 5% tax rate for such part of their business before the tax reform pilot program takes effect, may face unfavorable tax consequences, which may adversely affect our business, financial condition and results of operations.

PRC laws and regulations establish complex procedures for some acquisitions of Chinese companies by foreign investors, which could make it more difficult for us to pursue growth through acquisitions in China.

PRC laws and regulations, such as the M&A Rules promulgated by six PRC regulatory agencies in 2006 and amended in 2009, the Anti-Monopoly Law promulgated by the PRC National People s Congress in 2007 and the Circular on the Establishment of a National Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors promulgated by the General Office of the PRC State Council in 2011, or the National Security Review Mechanism Circular, establish procedures and requirements that could make some acquisitions of Chinese companies by foreign investors and companies more time-consuming and complex, including requirements in some instances that various governmental authorities be notified in advance of any change-of-control transaction in which a foreign investor takes control of a PRC domestic enterprise.

In addition, the Rules of Ministry of Commerce on Implementation of Security Review Mechanism of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors promulgated by the MOFCOM in August 2011, or the MOFCOM Security Review Rules, effective September 1, 2011, which implements the National Security Review Mechanism Circular, provides that, a security review by MOFCOM is required for mergers and acquisitions of PRC domestic enterprises by foreign investors (i) having national defense and security concerns, and (ii) where the foreign investors may acquire the de facto control of the PRC domestic enterprises having national security concerns such as key farm products, key energy and resources, and key infrastructure, transportation, technology and major equipment manufacturing industries. Neither the National Security Review Mechanism Circular nor the MOFCOM Security Review Rules, however, defines the term of key or major, nor has it exhausted all the industries that may be deemed as sensitive industries subject to the security review. When deciding whether a specific merger or acquisition of a domestic enterprise by foreign investors is subject to MOFCOM s security review, the principle of substance over form should be applied and foreign investors are prohibited from bypassing the security review requirement by way of structuring transactions through proxies, trusts, indirect investments, leases, loans, control through contractual arrangements or offshore transactions. We may expand our business in part by acquiring complementary businesses. Complying with the requirements of the relevant PRC laws and regulations to complete such transactions could be time-consuming, and any required approval processes may delay or inhibit our ability to complete such transactions, which could affect our ability to expand our business or maintain our market share.

We and our investors face uncertainty with respect to indirect transfers of equity interests in PRC resident enterprises by their non-PRC holding companies.

In connection with the New EIT Law, the Ministry of Finance and State Administration of Taxation jointly issued, on April 30, 2009, the Notice on Issues Concerning Process of Enterprise Income Tax in Enterprise Restructuring Business, or Circular 59. On December 10, 2009, the State Administration of Taxation issued the Notice on Strengthening the Management on Enterprise Income Tax for Non-resident Enterprises Equity Transfer, or Circular 698. Both Circular 59 and Circular 698 are effective retroactively to January 1, 2008. Under the two circulars, non-PRC-resident enterprises may be subject to income tax on capital gains generated from their transfers of equity interests in PRC resident enterprises, or an Indirect Transfer. Using a substance over form principle, the PRC tax authorities have discretion under Circular 59 and Circular 698 to make adjustments to the taxable capital gains based on the difference between the fair value of the equity interests transferred and the cost of the investment. In addition, by promulgating and implementing the circulars, the PRC tax authorities have increased their scrutiny of the direct or indirect transfer of equity interests in a PRC resident enterprise by a non-PRC-resident enterprise. For example, Circular 698 specifies that the PRC State Administration of Taxation is entitled to redefine the nature of an equity transfer where offshore vehicles are interposed for tax-avoidance purposes and without reasonable commercial purpose.

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There is uncertainty as to the application of Circular 698. For example, while the term Indirect Transfer is not clearly defined, it is understood that the relevant PRC tax authorities have jurisdiction regarding requests for information over a wide range of foreign entities having no direct contact with China. Moreover, the implementation of Circular 698, such as the process and format of the reporting of an Indirect Transfer to the competent tax authority of the relevant PRC resident enterprise remains unclear. In addition, there are not any formal declarations with regard to how to determine whether a foreign investor has adopted an abusive arrangement in order to reduce, avoid or defer PRC tax. Circular 698 may be determined by the tax authorities to be applicable to our private equity financing transactions, disposal of our subsidiaries, acquisitions of complementary businesses, or disposal of shares or ADSs in our company, where non-PRC resident investors are involved. As a result, we and our non-PRC resident investors may, when doing transactions that involve the transfer of our shares or equity interests of our subsidiaries, become at risk of being taxed under Circular 698 and may be required to expend valuable resources to comply with Circular 698 or to establish that we or our non-PRC resident shareholders should not be taxed under Circular 698, which may have a material adverse effect on our financial condition and results of operations or such non-PRC resident investors investments in us.

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Intensified government regulation of internet cafés could limit our ability to maintain or increase our net revenues and expand our customer base.

Starting in 2001, the Chinese government began tightening its supervision of internet cafés, closing unlicensed internet cafés, requiring those remaining open to install software to prevent access to sites deemed subversive and requiring web portals to sign a pledge not to host subversive sites. In February 2007, 14 PRC national government authorities, including the MIIT, the Ministry of Culture and the General Administration of Press and Publication, jointly issued a notice suspending nationwide approval for the establishment of new internet cafés beginning 2007 and enhancing the punishment for internet cafés admitting minors. This suspension may continue indefinitely. Furthermore, the Chinese government s policy, which encourages the development of a limited number of national and regional internet café chains and discourages the establishment of independent internet cafés, may slow down the growth of internet cafés.

As internet cafés are the primary venue for users to play our games, any reduction in the number, or any slowdown in the growth, of internet cafés in China will limit our ability to maintain or increase our net revenues and expand our customer base, which will in turn materially and adversely affect our business and results of operations.

The laws and regulations governing the online game industry in China are developing and subject to future changes. If we fail to obtain or to maintain all applicable permits and approvals, our business and operations would be materially and adversely affected.

The internet industry, including the operation of online games, in China is highly regulated by the PRC government. Various regulatory authorities of the central PRC government, such as the State Council, the MIIT, the State Administration for Industry and Commerce, or the SAIC, the MOC, GAPP, the State Administration of Radio, Film and Television, and the Ministry of Public Security, are empowered to promulgate and implement regulations governing various aspects of the internet and the online game industry.

We are required to obtain applicable permits or approvals from different regulatory authorities in order to provide online game services. For example, an internet content provider, or ICP, must obtain a value-added telecommunications business operation license, or ICP license, from the MIIT or its local offices in order to engage in any commercial ICP operations within China. An online game operator must also obtain an internet culture operation license from the MOC, and an internet publishing license from GAPP, in order to operate and distribute games through the internet. Giant Network holds a valid ICP License, a valid internet culture operation license and a valid internet publishing license. As the online game industry is at its early stage of development in China, new laws and regulations may be adopted from time to time to require additional licenses and permits other than those we currently have. While we believe that we comply in all material respects with all applicable PRC laws and regulations currently in effect, we cannot assure you that we will be able to obtain timely, or at all, required licenses or any other new license required in the future. We also cannot assure you that we will not be found in violation of any current or future PRC laws and regulations.

Further strengthened supervision of the online game industry may adversely affect our online game operations.

The authority, roles and responsibilities of the 22 PRC governmental departments with oversight of the online game industry in China, including GAPP and the MOC, are currently ambiguous and we may face stricter scrutiny in the future regarding the day-to-day operations of our online game business. For example, our online game business may be adversely affected by ambiguities and potential conflicts between notices issued by GAPP and the MOC. GAPP initially stated in the GAPP Notice that it is the only governmental department with authority for examination and pre-approval of online games, and that all online game operators must obtain an internet publishing license to provide online game services. Pursuant to the GAPP Notice, additional approvals from GAPP are required when game operators release new versions or expansion packs, or make any changes to the originally approved online game. In addition, on July 1, 2009, GAPP issued the Notice on Strengthening the Approval and Administration of Imported Online Games, in which GAPP stated that it is the only governmental department authorized by the State Council to approve the importation of online games from offshore copyright owners. In the event of any failure to meet the above-mentioned requirements, an operator may face heavy penalties, such as being ordered to stop operation, or having its business license revoked. Our online game business may be adversely affected by these two GAPP notices. The launch of expansion packs and imported games might be delayed because of the extra approval required. Such delay in releasing expansion packs or imported games may result in higher costs for our online game operation and have an adverse effect on our game revenue.

On June 3, 2010, the MOC issued the Tentative Measures for Online Game Administration, or the Online Game Measures, which became effective on August 1, 2010, aiming to further strengthen the MOC s supervision of the online game industry. Specifically, the Online Game Measures reiterate that the MOC has the power to review the content of all online games except online game publications that have been pre-approved by GAPP. However, the Online Game Measures do not clearly specify what constitutes online game publication. Furthermore, the Online Game Measures provide that all domestic online games must be filed with the MOC within 30 days after their launch, while all imported online games are subject to a content review prior to their launch. If a substantial change (for example, any significant modification to a game s storyline, language, tasks, or trading system) is made to an existing imported or domestic online game, it will be subject to a new content review.

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Our online game business may be adversely affected by the Online Game Measures. The Online Game Measures do not set forth any specific procedure for the required filing and content review procedures for online games and therefore may cause delay when we try to file or apply for content review with the MOC. In addition, the Online Game Measures do not resolve certain inconsistencies and ambiguities resulting from pronouncements included in previous notices issued by GAPP and the MOC. Due to the ambiguities here and elsewhere regarding the 22 governmental departments, including GAPP and the MOC, that have oversight of the online game industry, there may potentially be stricter and more abrupt scrutiny of our operations. If any of our online game operating entities cannot comply with any of the stipulations of any PRC governmental department regarding the online game industry, we may be subject to various penalties and our online game business may be adversely affected.

Regulation and censorship of information disseminated over the internet in China may adversely affect our business, and we may be liable for information displayed on, retrieved from, or linked to our websites.

The PRC government has adopted regulations governing internet access and the distribution of news and other information over the internet. Under these regulations, internet content providers and internet publishers are prohibited from posting or displaying over the internet any content that, among other things, violates PRC laws and regulations, impairs the national dignity of China, or is obscene, superstitious, fraudulent or defamatory. When internet content providers and internet publishers, including online game operators, find that information falling within the above scope is transmitted on their websites or is stored in their electronic bulletin service systems, they are required to terminate the transmission of such information or delete such information immediately, keep records, and report to relevant authorities. Failure to comply with these requirements could result in the revocation of our ICP license and other required licenses and the closure of our websites. Website operators may also be held liable for prohibited information displayed on, retrieved from or linked to their websites.

In addition, the MIIT has published regulations that subject website operators to potential liability for the actions of game players and others using their websites, including liability for violations of PRC laws prohibiting the dissemination of content deemed to be socially destabilizing.

As a result, we periodically make changes to our games based on feedback gathered from users and in order to comply with government regulations. For example, during the third quarter of 2009, we canceled several in-game monetization features in compliance with a virtual currency regulation issued by the Ministry of Culture, or MOC. The most important cancelled feature was the virtual treasure box, which contained in-game items worth more than the cost of the treasure box itself. We believe this change was the main reason for the subsequent temporary decrease in our active paying players, which fell by 7.9%, from approximately 1,204,000 during the second quarter of 2009 to approximately 1,108,000, during the third quarter of 2009. Future rule changes to our games could lead to declines in active paying players, which may materially and adversely affect our business, results of operation and financial condition.

As these regulations are subject to interpretation by the relevant authorities, it may not be possible for us to determine in all cases the type of content that could result in liability for us as an MMORPG developer and operator. In addition, we may not be able to control or restrict the content of other internet content providers linked to or accessible through our websites, or content generated or placed on our websites by our game players, despite our attempt to monitor such content. To the extent that regulatory authorities find any portion of our content objectionable, they may require us to curtail our games, which may reduce our game player base, the amount of time our games are played or the purchases of virtual items.

Compliance with the laws or regulations governing virtual currency may result in us having to obtain additional approvals or adversely affect our game operation revenues.

In June 2009, the MOC and the Ministry of Commerce jointly published the Notice on Strengthening the Administration Work of the Virtual Currency in Online Games, or the Virtual Currency Notice, to require businesses that (i) issue online game virtual currency (in the form of prepaid cards and/or pre-payment or prepaid card points) or (ii) offer online game virtual currency transaction services to apply for approval from the MOC through its provincial branches within three months following the date of such 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 but not limited to warnings, mandatory corrective measures and fines. The Virtual Currency Notice also prohibits online game operators from allocating 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. In addition, the Virtual Currency Notice regulates, among other things, that game operators may not issue virtual currency to game players through means other than purchased by game players with legal currency. Moreover, any businesses that do not provide online game virtual currency transaction services are required to adopt technical measures to restrict the transfer of online game virtual currency among accounts of different game players. The MOC issued the Tentative Measures for Online Games Administrative, or the Online Game Measures, in June 2010, which provides, among other things, that virtual currency issued by online game operators may only be used in exchange for the operator s own online game products and services and may not be used to pay for the products and services of other entities. The above restrictions may limit our ability to maintain or increase our revenues and adversely affect our results of operations and business prospects.

The PRC State Administration of Taxation has also previously announced that it will tax game players on the income derived from the trading of virtual currencies at the rate of 20%. However, it is currently unclear how the tax will be collected or if there will be any effect on our game players or our business.

There are currently no laws or regulations in the PRC governing virtual asset property rights and therefore it is not clear what liabilities, if any, online game operators may have relating to the loss of virtual assets.

In the course of playing online games, some virtual assets, such as special equipment, player experience grades and other features of our players game characters, are acquired and accumulated. Such virtual assets can be highly valued by online game players and in some cases are traded between players for actual money or real assets. In practice, virtual assets can be lost for various reasons, such as data loss caused by delay of network service or by a network crash. There are currently no PRC laws and regulations governing virtual asset property rights. As a result, it is unclear who the legal owner of virtual assets is and whether the ownership of virtual assets is protected by law. In addition, it is unclear under PRC law whether an operator of online games such as us would have any liability (whether in contract, tort or otherwise) for loss of such virtual assets by game players. In the event of a loss of virtual assets, we may be sued by players and may be held liable for damages, which may negatively affect our business, financial condition and results of operations.

Our business may be adversely affected by public opinion and government policies in China.

Due to a relatively high degree of game player loyalty, easy access to personal computers and internet cafés, and the lack of other appealing forms of entertainment in China, many teenagers in China frequently play online games. This may result in these teenagers spending less time on or refraining from other activities, including education, vocational training, and sports, which could result in adverse public reaction and stricter government regulation. For example, the PRC government has promulgated anti-fatigue-related regulations to limit the amount of time minors can play online games. See Risk Factors Risks Related to the Regulation of Our Business Our operations may be adversely affected by a broadening of the addiction-related regulations. The PRC government has also tightened its regulations on internet cafés, currently one of the primary places where online games are played, including limiting the issuance of internet café operating licenses and imposing higher capital and facility requirements for the establishment of internet cafés. See Risk Factors Risks Related to the Regulation of Our Business Intensified government regulation of internet cafés could limit our ability to maintain or increase our net revenues and expand our customer base. In addition, in January 2011, MIIT and seven other central government authorities jointly issued a circular pursuant to which online game operators are required to maintain a system to communicate with the parents of minors that play the operator s online games, to monitor the activities of the minors and to suspend their accounts if so requested by their parents.

Adverse public opinion, and the stricter government regulations that often result there from, could discourage game players from playing our games and could result in government regulations that impose additional limitations on the operations of online games. For example, in January 2011, the MOC, MIIT and six other central government authorities jointly issued a circular entitled Implementation of Online Game Monitor System of the Guardians of Minors, or the Monitor System Circular, under which online game operators are required to adopt various measures to maintain a system to communicate with the parents or other guardians of minors playing online games and are required to monitor the activities of the minors and suspend the accounts of minors if so requested by their parents or guardians. Additional government regulations, whether issued in response to adverse public opinion or otherwise, could be issued in the future and may have a material and adverse effect upon our business, results of operation and financial condition.

Regulations relating to offshore investment activities by PRC residents may increase our administrative burdens and create regulatory uncertainties that could restrict our overseas and cross-border investment activity, and a failure by our shareholders who are PRC residents to make any required applications and filings pursuant to such regulations may prevent us from being able to distribute profits and could expose us and our PRC resident shareholders to liability under PRC law.

In October 2005, the State Administration of Foreign Exchange, or the SAFE, promulgated a Notice on Issues Relating to the Administration of Foreign Exchange in Fund-raising and Return Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies, or Notice 75, which states that if PRC residents use assets or equity interests in their PRC entities as capital contributions to establish offshore companies or inject assets or equity interests of their PRC entities into offshore companies to raise capital overseas, they must register with local SAFE branches with respect to their overseas investments in offshore companies. They must also file amendments to their registrations if their offshore companies experience material events involving capital variation, such as changes in share capital, share transfers, mergers and acquisitions, spin-off transactions, long-term equity or debt investments or uses of assets in China to guarantee offshore obligations.

In addition, SAFE has further issued a series of implementation guidances, including the most recent Notice on Printing and Distributing the Implementing Rules for the Administration of Foreign Exchange in Fund-Raising and Round-trip Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies, or Circular 19, which was effective as of July 1, 2011. Circular 19 standardized more specific and stringent supervision on the registration and supplemental registration for established special purpose vehicles, or SPVs, relating to

Notice 75. Under these regulations, a PRC resident s failure to comply with the registration procedures set forth in such regulations may result in fines or sanctions imposed by the PRC government, including restrictions being imposed on the foreign exchange activities of the relevant PRC entity, including the payment of dividends and other distributions to its offshore parent, as well as restrictions on the capital inflow from the offshore entity to the PRC entity.

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We are committed to complying with and to ensuring that our shareholders who are subject to the regulations comply with the relevant rules. However, we cannot assure you that all of our shareholders who are PRC residents will comply with our request to make or obtain any applicable registrations or comply with other requirements required by Notice 75 or other related rules. Any failure by any of our shareholders who are PRC residents, or controlled by a PRC resident, to comply with relevant requirements under this regulation could subject us to fines or sanctions imposed by the PRC government, including restrictions on our PRC subsidiaries abilities to pay dividends or make distributions to us and our ability to increase our investment in our PRC subsidiaries.

We may be subject to fines and legal sanctions if we or our employees fail to comply with recent PRC regulations relating to employee stock incentive plan granted by overseas listed companies to PRC domestic individuals.

In December 2006, the People s Bank of China, or PBOC, promulgated the Administrative Measures on Individual Person Foreign Exchange, or the PBOC Regulation, setting forth the respective requirements for foreign exchange transactions by individuals (both PRC or non-PRC citizens) under the current account and the capital account. In January 2007, SAFE issued the implementation rules for the PBOC Regulation which, among others, specified the approval requirement for certain capital account transactions such as a domestic individual s participation in the employee stock ownership plan or stock options plan of an overseas listed company. In February 2012, the SAFE promulgated the Notice on Issues Concerning the Foreign Exchange Administration for Domestic Individuals Participating in Stock Incentive Plan of Overseas-Listed Company, or the Stock Option Rule, which replaced the Implementing Procedures on Administration of Foreign Exchange regarding PRC Individuals Participating in Employee Stock Ownership Plan and Stock Option Plan of Overseas Listed Companies issued by SAFE on March 28, 2007. Under the Stock Option Rule, PRC domestic individuals who participate in any stock incentive plan including employee stock holding plan, stock option plan or similar plan of an overseas publicly-listed company are required, through a PRC agent of such overseas publicly-listed company, to register with the relevant local SAFE branch and complete certain other procedures and transactional foreign exchange matters related to the stock incentive plan. Under the Stock Option Rule, PRC domestic individuals include PRC citizens (including Hong Kong, Macao and Taiwan nationals) and foreign nationals who have continuously resided in China for at least a year, and a PRC agent may be a domestic company participating in the stock incentive plan or a domestic institution that is qualified to engage in assets custodian business and has been duly designated by a domestic company. Failure to comply with the Stock Option Rule may subject the plan participants, the company offering the plan or the relevant intermediaries, as the case may be, to fines and legal or administrative sanctions under PRC foreign exchange regime.

However, as a result of uncertainty concerning the reconciliation of the new regulation and ambiguities in SAFE registration procedures for registering PRC individuals share obtained from exercise of share options, 299 PRC individuals in all who have exercised their options to purchase our ordinary shares in accordance with our Employee Share Option Scheme in 2011 are currently unable to register their share ownership with Shanghai SAFE. These individuals are actively communicating with Shanghai SAFE to seek alternative solutions. We do not expect that the inability by those individuals to register share ownership with Shanghai SAFE will have a material adverse effect on our business. We are committed to complying, and to ensuring that our shareholders who are subject to the regulation comply, with the relevant rules. However, we cannot assure you that all of our shareholders who are PRC individuals will comply with our request to make or obtain any applicable registrations or approvals required by the regulation or other related legislation. The failure or inability of our PRC individual shareholders to receive any required approvals or make any required registrations may subject us to fines and legal sanctions, restrict our overseas or cross-border investment activities, limit our PRC subsidiary s ability to make distributions or pay dividends or affect our ownership structure, as a result of which our acquisition strategy and business operations and our ability to distribute profits to you could be materially and adversely affected.

Our operations may be adversely affected by a broadening of the addiction-related regulations.

The Chinese government may decide to adopt more stringent policies to monitor the online game industry to cover adult players as a result of adverse public reaction to perceived addiction to online games, particularly by minors. On April 15, 2007, eight PRC government authorities, including GAPP, the Ministry of Education and the MIIT issued a Notice on the Implementation of Online Game Anti-Addiction System to Protect the Physical and Psychological Health of Minors, or the Anti-Addiction Notice, requiring all Chinese game operators to adopt an anti-addiction system in an effort to curb addiction to online games by minors. Under the anti-addiction system, three hours or less of continuous play is defined to be healthy, three to five hours is defined to be fatiguing, and five hours or more is defined to be unhealthy. Game operators are required to reduce the value of game benefits for minor players by half when those players reach the fatigue level, and to zero when they reach the unhealthy level. In addition, online game players in China are now required to register their identity card numbers before they can play an online game, which allows game operators to identify which players are minors. Failure to comply with the requirements under the Anti-Addiction Notice may subject us to penalties, including but not limited to suspension of our operation of online games, revocation of our licenses and approvals for our operations, rejection or suspension of our application for approvals, licenses, or filings for any new game, or prohibiting us from operating any new game. Although we currently do not permit minors to play our online games, if these restrictions are expanded to apply to adult players in the future, they could have a material and adverse effect on our business, financial condition and operating results.

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On July 1, 2011, eight PRC government authorities, including the GAPP, the Ministry of Education, MIIT and five others, promulgated a further notice to strengthen the implementation of the anti-addiction system and real-name registration, entitled the Notice on Initializing the verification of Real-name Registration for Anti-Addiction System on Internet Games, or the Real-name Registration Notice, which took effect on October 1, 2011. The Real-name Registration Notice s main focus is to prevent minors from using an adult s ID to play Internet games and, accordingly, the notice provides more stringent punishment for online game operators for not implementing the anti-addiction and real name registration measures properly and effectively. The most severe punishment contemplated by the Real-name Registration Notice includes suspension of operation of online games, revocation of game operator s licenses and approvals, rejection or suspension of game operator s application for approvals, licenses, or filings for any new game if such game operator is found to be in violation of any of the government issued notices including the Anti-Addiction Notice, the Monitor System Circular or the Real-name Registration Notice. The Real-name Registration Notice further increases our operating risks, as we will be required to allocate more resources to real-name verification and anti-addiction systems, which may lead to an increase in operating costs. In addition, the amount of time that minors will be able to spend playing online games such as ours will be further limited, which may cause a reduction in our revenues. Furthermore, if we are found to be violating the Real-name Registration Notice, we may be required to suspend or discontinue our online game operations.

Our holding company structure may restrict our ability to receive dividends from, or transfer funds to, our PRC subsidiaries and our PRC affiliated entities, which could restrict our ability to act in response to changing market conditions and reallocate funds among our Chinese entities in a timely manner.

We are a Cayman Islands holding company and conduct substantially all of our operations through our PRC subsidiaries and affiliated entities. We may rely on dividends and other distributions on equity by our PRC subsidiaries for our cash requirements, including the funds to pay dividends on the ordinary shares underlying our ADSs. Furthermore, under PRC laws and regulations, each PRC subsidiary is only permitted to pay dividends out of its retained earnings, if any, determined in accordance with PRC accounting standards and regulations. Under PRC law, each PRC subsidiary is also required to set aside at least 10% of its after-tax profit based on PRC accounting standards each year to its general reserves until the cumulative amount of such reserves reaches 50% of its registered capital. These reserves are not distributable as cash dividends, loans or advances. Each PRC subsidiary may also allocate a portion of its after-tax profits, as determined by its board of directors, to its staff welfare and bonus funds, which may not be distributed to us. As a result of these and other restrictions under PRC laws and regulations, each PRC subsidiary is restricted from transferring a portion of its assets to us as dividends, loans or advances, which restricted portion amounted to approximately RMB211.0 million and RMB368.8 million (US$58.6 million), or 3.3% and 14.8% of our total consolidated net assets as of December 31, 2010 and 2011, respectively. Any limitation on the ability of our PRC subsidiaries to transfer funds to us as dividends, loans or advances could materially and adversely limit our ability to make offshore investments or acquisitions that could benefit our businesses and pay dividends.

In addition, any funds we transfer to our PRC subsidiaries, either as a shareholder loan or as an increase in registered capital, is subject to registration or approval of PRC governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. Each entity of our PRC subsidiaries and affiliated entities is prohibited by PRC law to directly lend money to another. Therefore, it is difficult to change our capital expenditure plans once the relevant funds have been remitted from our company to our PRC subsidiaries and affiliated entities. These limitations on the free flow of funds between us and our PRC subsidiaries and affiliated entities could restrict our ability to act in response to changing market conditions and reallocate funds among our PRC subsidiaries and affiliated entities on a timely basis.

Risks Relating to China

Our business, financial condition and results of operations, as well as our ability to obtain financing, may be adversely affected by the downturn in the global or Chinese economy. In addition, we may be adversely affected by the possible hard landing of China s economy in the future.

The global financial markets have experienced significant disruptions since 2008, the economic effects of which have persisted through 2011. China s economy has also faced challenges. To the extent that there have been improvements in some areas, it is uncertain whether such recovery is sustainable, in particular under current European economic and sovereign debt crisis. Because substantially all of our business operations are conducted in China, our business and prospects may be materially and adversely affected by any deterioration in China s macroeconomic environment.

There is a possibility that China s economic growth rate may materially decline in the near future, which may have adverse effects on our financial condition and results of operations. Risk of a material slowdown in China s economic growth rate is based on several current or emerging factors including: (i) overinvestment by the government and businesses and excessive credit offered by banks; (ii) a rudimentary monetary policy; (iii) excessive privileges to state-owned enterprises at the expense of private enterprises; (iv) the dwindling supply of surplus labor; (v) a decrease in exports due to weaker demand overseas; and (vi) failure to boost domestic consumption. Although we are uncertain about the extent to which the recent global financial and economic crisis and potential rapid slowdown of China s economic growth may impact our business in the short term and long term, there is a risk that our business, results of operations and prospects would be materially and adversely affected by any ongoing global economic downturn or slowdown of China s growth rate.

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The PRC legal system embodies uncertainties which could limit the legal protections available to you and us.

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the PRC government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. The overall effect of legislation over the past three decades has significantly enhanced the protections afforded to various forms of foreign investment in China. Our PRC subsidiary, Zhengtu Information, is a foreign-invested enterprise incorporated in China. It is subject to laws and regulations applicable to foreign investment in China in general and laws and regulations applicable to foreign-invested enterprises in particular. However, these laws, regulations and legal requirements change frequently, and their interpretation and enforcement involve uncertainties. For example, we may have to resort to administrative and court proceedings to enforce the legal protection that we enjoy either by law or contract. However, since PRC administrative and court authorities have significant discretion in interpreting and implementing statutory and contractual terms, it may be more difficult to evaluate the outcome of administrative and court proceedings and the level of legal protection we enjoy than in more developed legal systems. In addition, such uncertainties, including the inability to enforce our contracts, could materially and adversely affect our business and operations. Furthermore, the PRC legal system is based in part on government policies and internal rules (some of which are not published on a timely basis or at all) that may have a retroactive effect. As a result, we may not be aware of our violation of these policies and rules until sometime after the violation. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention. Furthermore, intellectual property rights and confidentiality protections in China may not be as effective as in the United States or other countries. Accordingly, we cannot predict the effect of future developments in the PRC legal system, particularly with regard to the online game industry, including the promulgation of new laws, changes to existing laws or the interpretation or enforcement thereof, or the preemption of local regulations by national laws. These uncertainties could limit the legal protections available to us, and our foreign investors, including you.

Restrictions on the convertibility of Renminbi into foreign currencies may limit our ability to make dividends or other payments in U.S. dollars or fund possible business activities outside China.

Substantially all of our net revenues are currently generated in Renminbi. Any future restrictions on currency exchanges may limit our ability to use net revenues generated in Renminbi to make dividends or other payments in U.S. dollars or fund possible business activities outside China. Although the PRC government introduced the Foreign Exchange Administration Rules in 1996, as amended in August 2008, to allow greater convertibility of Renminbi for current account transactions, significant restrictions still remain, including primarily the restriction that enterprises may only buy, sell and/or remit foreign currencies at those banks authorized to conduct foreign exchange business after providing valid commercial documents. In addition, remittance of foreign currencies abroad and conversion of Renminbi for capital account items, including direct investment and loans, is subject to government approval in China, and companies are required to open and maintain separate foreign exchange accounts for capital account items. We cannot assure you the Chinese regulatory authorities will not impose more stringent restrictions on the convertibility of Renminbi, especially with respect to foreign exchange transactions.

You may experience difficulties in effecting service of legal process, enforcing foreign judgments or bringing original actions in China based on United States or other foreign laws against us, our management or the experts named in the annual report.

We conduct substantially all of our operations in China and substantially all of our assets are located in China. In addition, all of our directors and executive officers reside within China. As a result, it may not be possible to effect service of process within the United States or elsewhere outside China upon some of our directors and senior executive officers, including with respect to matters arising under U.S. federal securities laws or applicable state securities laws. It would also be difficult for investors to bring an original lawsuit against us or our directors or executive officers before a Chinese court based on U.S. federal securities laws or otherwise.

Fluctuation in the value of the Renminbi may have a material adverse effect on your investment.

The value of the Renminbi against the U.S. dollar and other currencies is affected by, among other things, changes in China s political and economic conditions and China s foreign exchange policies. The conversion of Renminbi into foreign currencies, including U.S. dollars, was historically based on exchange rates set by the PBOC. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the Renminbi solely to the U.S. dollar. Under this revised policy, the Renminbi is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. Following the removal of the U.S. dollar peg, the Renminbi has appreciated more than 5% against the U.S. dollar as of the end of 2011.

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Substantially all of our revenues and costs are denominated in Renminbi. Any significant revaluation of the Renminbi may materially inflate our revenues and earnings as expressed in U.S. dollars without reflecting any material change in our results of operations.

The audit report included in this annual report are prepared by auditors who are not inspected by the Public Company Accounting Oversight Board and, as such, our investors are deprived of the benefits of such inspection

Our independent registered public accounting firm that issues the audit reports included in our annual reports filed with the US Securities and Exchange Commission, as auditors of companies that are traded publicly in the United States and a firm registered with the US Public Company Accounting Oversight Board (United States) (the PCAOB), is required by the laws of the United States to undergo regular inspections by the PCAOB to assess its compliance with the laws of the United States and professional standards. Because our auditors are located in the Peoples Republic of China, a jurisdiction where the PCAOB is currently unable to conduct inspections without the approval of the Chinese authorities, our auditors are not currently inspected by the PCAOB.

Inspections of other firms that the PCAOB has conducted outside China have identified deficiencies in those firms audit procedures and quality control procedures, which may be addressed as part of the inspection process to improve future audit quality. This lack of PCAOB inspections in China prevents the PCAOB from regularly evaluating our auditor s audits and its quality control procedures. As a result, investors may be deprived of the benefits of PCAOB inspections.

The inability of the PCAOB to conduct inspections of auditors in China makes it more difficult to evaluate the effectiveness of our auditor s audit procedures or quality control procedures as compared to auditors outside of China that are subject to PCAOB inspections. Investors may lose confidence in our reported financial information and procedures and the quality of our financial statements.

Risks Related to Our Ordinary Shares and ADSs

The market price for our ADSs may be volatile which could result in a loss to you.

The trading price of our ADSs has been and may continue to be subject to wide fluctuations. Since we completed our initial public offering on November 6, 2007, the closing price of our ADSs on the New York Stock Exchange has ranged from US$3.02 to US$20.46 per ADS and the last reported closing price on April 20, 2012 was US$5.44.

The market price for our ADSs is likely to be highly volatile and subject to wide fluctuations in response to a number of factors, including:

- actual or anticipated fluctuations in our quarterly operating results;
- announcements of competitive developments;
- changes in the economic performance or market valuations of companies with comparable businesses;
- negative market and investor perception in response to recent accounting irregularities at other Chinese companies listed in the U.S.;
- regulatory developments in China affecting us, our industry, our corporate structure or our advertisers;
- announcements regarding litigation or administrative proceedings involving us;
- changes in financial estimates by securities research analysts;

- addition or departure of our executive officers;
- issuance of material dividends; and
- sales or perceived sales of additional common shares or ADSs.

For example, on September 12, 2011, the trading price of our ADS declined from US$8.00 to US$4.61, which was primarily due to a special cash dividend of US$3 per ADS that we issued to our shareholders as of record August 31, 2011.

In addition, the securities market has from time to time experienced significant price and volume fluctuations that are not related to the operating performance of particular companies. These market fluctuations may also have a material adverse effect on the market price of our ADSs.

Future sales or perceived sales of ADSs or ordinary shares by our controlling shareholders could cause our ADS price to decline.

If our existing shareholders sell, indicate an intention to sell or are perceived to intend to sell substantial amounts of our ordinary shares in the public market, the trading price of our ADSs could decline. As of March 31, 2012, we had 236,396,009 outstanding ordinary shares, of which 131,228,540 or 55.51% were beneficially owned by Yuzhu Shi, our founder, chairman and chief executive officer, and his daughter Ms. Jing Shi. If Mr. Shi or his daughter decides to sell any of these shares or if it is perceived that they will be sold in the public market, the trading price of our ordinary shares could decline.

Our corporate actions are substantially controlled by our principal shareholder.

As of March 31, 2012, Yuzhu Shi, our chairman and chief executive officer, and his daughter Jing Shi, together beneficially owned approximately 55.51% of our outstanding ordinary shares. These shareholders, acting individually or as a group, could exert control over and substantially influence matters such as electing directors and approving investments, mergers or other business combination transactions. This concentration of ownership and voting power may also discourage, delay or prevent a change in control of our company, which could deprive our shareholders of an opportunity to receive a premium for their shares as part of a sale of our company that might reduce the price of our ADSs. These actions may be taken even if they are opposed by our other shareholders.

We may be classified as a passive foreign investment company, which could result in adverse U.S. federal income tax consequences to U.S. holders of our ADSs or ordinary shares.

Depending upon the value of our ADSs or ordinary shares and the nature of our assets and income over time, we could be classified as a passive foreign investment company or PFIC for U.S. federal income tax purposes. We will be classified as a PFIC in any taxable year if either: (a) the average quarterly value of our gross assets that produce passive income, or are held for the production of passive income, is at least 50% of the average quarterly value of our total gross assets or (b) 75% or more of our gross income for the taxable year is passive income. According to these technical rules, we would likely become a PFIC for a given taxable year if our market capitalization were to decrease significantly while we hold substantial cash and cash equivalents in that year.

We believe that we were not a PFIC for U.S. federal income tax purposes for our taxable year ended December 31, 2011. However the application of the PFIC rules is subject to uncertainty in several respects, and we must make a separate determination after the close of each taxable year as to whether we were a PFIC for such year. As such, although we intend to conduct our business activities in a manner to reduce the risk of our classification as a PFIC in the future, we currently hold, and expect to continue to hold, a substantial amount of cash and other passive assets, and, because the value of our assets is likely to be determined in large part by reference to the market prices of our ADSs and ordinary shares, which are likely to fluctuate, there can be no assurance that we will not be classified as a PFIC for 2012 or any future taxable year. If we are a PFIC for any taxable year during which a U.S. investor held our ADSs or ordinary shares, certain adverse U.S. federal income tax consequences would apply to the U.S. investor. See Item 10, Additional Information Taxation U.S. Federal Income Taxation Passive foreign investment company.

Your right to participate in any future rights offerings may be limited, which may cause dilution to your holdings and you may not receive cash dividends if it is impractical to make them available to you.

We may from time to time distribute rights to our shareholders, including rights to acquire our securities. However, we cannot make rights available to you in the United States unless we register the rights and the securities to which they relate under the Securities Act or an exemption from the registration requirements is available. Also, under the deposit agreement, the depositary will not make rights available to you unless both the rights and any related securities are registered under the Securities Act, or the distribution of them to ADS holders is exempted from registration under the Securities Act. We are under no obligation to file a registration statement with respect to any such rights or securities or to endeavor to cause such a registration statement to be declared effective. Moreover, we may not be able to establish an exemption from registration under the Securities Act. Accordingly, you may be unable to participate in our rights offerings and may experience dilution in your holdings.

In addition, the depositary of our ADSs has agreed to pay to you the cash dividends or other distributions it or the custodian receives on our common shares or other deposited securities after deducting its fees and expenses. You will receive these distributions in proportion to the number of common shares your ADSs represent. However, the depositary may, at its discretion, decide that it is impractical to make a distribution available to any holders of ADSs. For example, the depositary may determine that it is not practicable to distribute certain property through the mail, or that the value of certain distributions may be less than the cost of mailing them. In these cases, the depositary may decide not to distribute such property and you will not receive such distribution.

As we are a Cayman Islands company, you may face difficulties in protecting your interests, and our ability to protect our rights through the U.S. federal courts may be limited. You may have less protection of your shareholder rights than you would if we were incorporated in a U.S. jurisdiction.

Our corporate affairs are governed by our amended and restated memorandum and articles of association, the Companies Law of the Cayman Islands and the common law of the Cayman Islands. The rights of our shareholders to take action against the directors, actions by non controlling shareholders and the fiduciary responsibilities of our directors under Cayman Islands law are to a large extent governed by the common law of the Cayman Islands. The common law of the Cayman Islands is derived in part from comparatively limited judicial precedent in the Cayman Islands as well as that from the English common law, which has persuasive, but not binding, authority on a court in the Cayman Islands. The rights of our shareholders and the fiduciary responsibilities of our directors under Cayman Islands law are not as clearly established as they would be under statutes or judicial precedents in some jurisdictions in the United States. In particular, the Cayman Islands has a less developed body of securities law as compared to the United States, and provides significantly less protection to investors. In addition, Cayman Islands companies may not have standing to initiate a shareholder derivative action in the federal court of the United States.

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Moreover, most of our directors and officers are nationals and residents of countries other than the United States. Substantially all of our assets and a substantial portion of the assets of these persons are located outside the United States.

The Cayman Islands courts are also unlikely:

- to recognize or enforce against us judgments of courts of the United States based on certain civil liability provisions of U.S. securities laws; and

- to impose liabilities against us, in original actions brought in the Cayman Islands, based on certain civil liability provisions of U.S. securities laws that are penal in nature.

There is no statutory recognition in the Cayman Islands of judgments obtained in the United States, although the courts of the Cayman Islands will generally recognize as a valid judgment a final and conclusive judgment in *personam* obtained in the federal or state courts in the United States under which a sum of money is payable (other than a sum of money payable in respect of multiple damages, taxes or other charges of a like nature or in respect of a fine or other penalty) or, in certain circumstances, an in *personam* judgment for non-monetary relief, and would give a judgment based thereon provided that (a) such courts had proper jurisdiction over the parties subject to such judgment (b) such courts did not contravene the rules of natural justice of the Cayman Islands, (c) such judgment was not obtained by fraud, (d) the enforcement of the judgment would not be contrary to the public policy of the Cayman Islands, (e) no new admissible evidence relevant to the action is submitted prior to the rendering of the judgment by the courts of the Cayman Islands, and (f) there is due compliance with the correct procedures under the laws of the Cayman Islands.

As a result of all of the above, our public shareholders may have more difficulties in protecting their interests in the face of actions by our management, directors or controlling shareholders than would shareholders of a public company incorporated in a jurisdiction in the United States.

You may have difficulties in enforcing judgments obtained against us.

We are incorporated in the Cayman Islands, and conduct all of our operations in China through our subsidiaries and affiliated entities established in China. All of our directors and officers reside outside the United States and substantially all of the assets of those persons are located outside the United States. As a result, it may be difficult or impossible for you to bring an action against us or against these individuals in the Cayman Islands or in China in the event that you believe that your rights have been infringed under the applicable securities laws or otherwise. Even if you are successful in bringing an action of this kind, the laws of the Cayman Islands and of China may render you unable to enforce a judgment against our assets or the assets of our directors and officers. For more information regarding the relevant laws of the Cayman Islands and China, see Risk Factors Risks Related to Our Ordinary Shares and ADSs You may have difficulties in enforcing judgments obtained against us and Risk Factors Risks Relating to China The PRC legal system embodies uncertainties which could limit the legal protections available to you and us.

Shareholders of Cayman Islands exempted companies such as ourselves have no general rights under Cayman Islands law to inspect corporate records and accounts or to obtain copies of lists of shareholders of these companies. Our directors have discretion under our articles of association to determine whether or not, and under what conditions, our corporate records may be inspected by our shareholders, but are not obliged to make them available to our shareholders. This may make it more difficult for you to obtain the information needed to establish any facts necessary for a shareholder motion or to solicit proxies from other shareholders in connection with a proxy contest.

Cayman Islands companies may not have standing to initiate a derivative action in a federal court of the United States. As a result, your ability to protect your interests if you are harmed in a manner that would otherwise enable you to sue in a United States federal court may be limited.

As a result of all of the above, public shareholders may have more difficulty in protecting their interests in the face of actions taken by management, members of the board of directors or controlling shareholders than they would as public shareholders of a U.S. company.

As a controlled company, we are exempt from certain New York Stock Exchange corporate governance requirements, which may result in our independent directors not having as much influence as they would if we were not a controlled company.

As of March 31, 2012, Yuzhu Shi, our founder, chairman and chief executive officer, and his daughter Ms. Jing Shi beneficially owned approximately 55.51% of the total voting rights in our company. As a result, we are a controlled company as defined under Section 303A of the Listed Company Manual of the New York Stock Exchange, or the NYSE. So long as we remain a controlled company as defined under that rule, we are exempt from certain NYSE corporate governance requirements, including:

that a majority of our board of directors consist of independent directors;

that we have a corporate governance and nominating committee that is composed entirely of independent directors; and

that we have a compensation committee that is composed entirely of independent directors.

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Although we voluntarily comply with the compensation committee, and the corporate governance and nominating committee requirements of the NYSE, we do not currently voluntarily comply with the requirement that a majority of our board of directors consist of independent directors. As a result of our reliance on the controlled company exemption, our independent directors might not have the same degree of influence on the decisions of our board of directors that they otherwise would.

The voting rights of holders of ADSs are limited in several significant ways by the terms of the deposit agreement.

Holders of our ADSs may only exercise their voting rights with respect to the underlying ordinary shares in accordance with the provisions of the deposit agreement. Upon receipt of voting instructions from a holder of ADSs in the manner set forth in the deposit agreement, the depositary will endeavor to vote the underlying ordinary shares in accordance with these instructions. Under our amended and restated memorandum and articles of association and Cayman Islands law, the minimum notice period required for convening a general meeting is five days. When a general meeting is convened, you may not receive sufficient notice of a shareholders meeting to permit you to withdraw your ordinary shares to allow you to cast your vote with respect to any specific matter at the meeting. In addition, the depositary and its agents may not be able to send voting instructions to you or carry out your voting instructions in a timely manner. We will make all reasonable efforts to cause the depositary to extend voting rights to you in a timely manner, but we cannot assure you that you will receive the voting materials in time to ensure that you can instruct the depositary to vote your shares. Furthermore, the depositary and its agents will not be responsible for any failure to carry out any instructions to vote, for the manner in which any vote is cast or for the effect of any such vote. As a result, you may not be able to exercise your right to vote and you may lack recourse if your ordinary shares are not voted as you requested.

The depositary of our ADSs will, except in limited circumstances, grant to us a discretionary proxy to vote the ordinary shares underlying your ADSs if you do not vote at shareholders meetings, which could adversely affect your interests and the ability of our shareholders as a group to influence the management of our company.

Under the deposit agreement for the ADSs, the depositary will give us a discretionary proxy to vote our ordinary shares underlying your ADSs at shareholders meetings if you do not vote, unless:

- we have failed to timely provide the depositary with our notice of meeting and related voting materials;
- we have instructed the depositary that we do not wish a discretionary proxy to be given;
- we have informed the depositary that there is substantial opposition as to a matter to be voted on at the meeting;
- a matter to be voted on at the meeting would have a material adverse impact on shareholders; or
- voting at the meeting is made on a show of hands.

The effect of this discretionary proxy is that you cannot prevent our ordinary shares underlying your ADSs from being voted, absent the situations described above, and it may make it more difficult for shareholders to influence the management of our company. Holders of our ordinary shares are not subject to this discretionary proxy.

You may not receive distributions on our ordinary shares or any value for them if it is illegal or impractical for us to make them available to you.

The depositary of our ADSs has agreed to pay you the cash dividends or other distributions it or the custodian for our ADSs receives on our ordinary shares or other deposited securities after deducting its fees and expenses. You will receive these distributions in proportion to the number of our ordinary shares your ADSs represent. However, the depositary is not responsible if it is unlawful or impractical to make a distribution available to any holders of ADSs. For example, it would be unlawful to make a distribution to a holder of ADSs if it consists of securities that require registration under the Securities Act but that are not properly registered or distributed pursuant to an applicable exemption from registration. The depositary is not responsible for making a distribution available to any holders of ADSs if any government approval or registration is required for such distribution. We have no obligation to take any other action to permit the distribution of our ADSs, ordinary shares, rights or anything else to holders of our ADSs. This means that you may not receive the distributions we make on our ordinary shares or any value for them if it is illegal or impractical for us to make them available to you. These restrictions may have a material and adverse effect on the value of your ADSs.

You may be subject to limitations on transfer of your ADSs.

Your ADSs, represented by American depositary receipts, are transferable on the books of the depositary. However, the depositary may close its books at any time or from time to time when it deems expedient in connection with the performance of its duties. The depositary may close its books from time to time for a number of reasons, including in connection with corporate events such as a rights offering, during which time the depositary needs to maintain an exact number of ADS holders on its books for a specified period. The depositary may also close its books in emergencies, and on weekends and public holidays. The depositary may refuse to deliver, transfer or register transfers of our ADSs generally when our books or the books of the depositary are closed, or at any time if we or the depositary thinks it is necessary or advisable to do so in connection with the performance of its duty under the deposit agreement, including due to any requirement of law or any government or governmental body, or under any provision of the deposit agreement.

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ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion of our financial condition and results of operations is based upon and should be read in conjunction with our consolidated financial statements and their related notes included in this amendment no.1 to our annual report on Form 20F/A. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. See Forward Looking Statements. In evaluating our business, you should carefully consider the information provided under Item 3.D, Key Information Risk Factors. in this amendment no. 1 to our annual report on Form 20-F/A. We caution you that our businesses and financial performance are subject to substantial risks and uncertainties.

A. Operating Results

Overview

We are a leading online game developer and operator in China in terms of market share. We focus on massively multiplayer online role playing games, or MMORPGs, which are played through networked game servers on which tens of thousands of players are able to simultaneously connect and interact.

We commercially launched our first internally-developed MMORPG game, ZT Online, in January 2006. We currently operate eleven online games, among which nine are self-developed, including the five games in the ZT Online franchise.

We offer virtual items and services available for in-game purchase in our free-to-play games. Players of our games can obtain virtual items and services by using game points purchased through our distribution network in the form of physical or virtual prepaid game cards or directly on our game website.

In addition to our historical success with internally developed games, we began to expand our game pipeline by licensing games from third party developers. In December 2009 and January 2010, respectively, we acquired the exclusive operation licenses for Elsword, a 3D Casual MMO, and Allods Online, a 3D MMORPG in China. Elsword was commercially launched in the fourth quarter of 2011 while Allods Online is expected to be launched later in 2012.

While we expect the MMORPG segment of China s online game industry to continue to grow, we nonetheless intend to develop additional games in other game segments such as webgame and mobile games. According to statistics released by GAPP in December 2011, game revenue generated in 2011 from webgames and mobile games were RMB5.54 billion (US$880 million) and RMB1.7 billion (US$270 million), respectively, which experienced year-over-year growth of approximately 32.4% and 86.8%, respectively. We believe webgames and mobile games will continue to enjoy a higher growth rate than MMORPG in the near future. As one of our key growth strategies for 2012, our webgame development is on track with six projects currently in production. These projects span various genres including an action role playing game based on the Three Kingdoms era, an action role playing game based on the core gameplay and features of the ZT Online franchise, an advanced 3D game using the Unity engine designed for international markets, a strategy game leveraging our experience from developing The Golden Land, and two casual games suitable for publication on social network platforms. These projects are expected to enter various stages of testing during the second half of 2012, with launches beginning then and in 2013. In addition, we began to explore growth and investment opportunities, recruit talents and seek domestic cooperation opportunities with game developers in the mobile game sector in 2011 and envision a cross platform strategy to enable our users to play our games on personal computers, tablets and mobile phones.

Although substantially all of our revenues are generated through our own game operations in China, we have begun to derive revenues from licensing our games to third party operators in other territories including Southeast Asia, Japan, South Korea, Brazil, North America, Europe, Russia and other Russian speaking territories since 2006.

In 2009, 2010 and 2011, our net revenues were RMB1,303.8 million, RMB1,332.8 million and RMB1,792.2 million (US$284.8 million), respectively. Our net income for the same years was RMB859.0 million, RMB807.6 million and RMB906.4 million (US$144.0 million), respectively. As of December 31, 2010 and December 31, 2011, deferred revenues and advances from distributors totaled RMB518.3 million and RMB611.5 million (US$97.2 million), respectively. Deferred revenues and advances from distributors represent amounts that we have received for sales of our prepaid game cards and game points that have not yet been recognized as net revenues. Our quarterly peak concurrent users for all of the games we operate in China were 1,713,000 and 2,339,000 for 2010 and 2011, respectively. Our quarterly average concurrent users for all of the games we operate in China were 595,000 and 642,000 for 2010 and 2011, respectively.

Factors Affecting Our Results of Operations

We have benefited from a number of trends that are currently accelerating the growth of the online game industry in China, including overall economic growth that has resulted in increased disposable income and discretionary consumer spending; increasing use of the internet with the growth of personal computers and broadband internet penetration; growing popularity of online games compared with other forms of entertainment; and favorable demographic trends, particularly the growth in China s core online game-playing population. However, recent competitiveness in the online game industry in China presents new challenges to our business.

Company-specific factors that may affect our future financial condition and results of operations include the following:

- the availability, quality and playability of our games;
- the number of games that we offer players, and our pricing relative to our competitors;
- the popularity of our competitors games and the growing competitiveness in the market;
- our research and development efforts, which tend to be more costly during the development stage of a new game, and ability to incorporate the latest gaming technologies and graphics into our games;
- the reorganization of our game development studios and the profit sharing mechanism in connection with such reorganization;
- costs of expansion and purchase of servers and equipment in anticipation of new games;
- changes in our game rules and the corresponding impact on player behavior and purchasing patterns;
- the quality, variety, popularity and mix of virtual items and services available for purchase in our free-to-play games and related in-game promotional efforts;
- licensee fees and royalty payments for games licensed from third party developers;
- the amount of overseas licensing net revenues generated through our licensing arrangements with operators of our games;
- our introduction of new online games, which may attract players away from our established games, and the mix of sales of our games;
- change in pricing strategies for our new games and its impact on our operating metrics;
- the mix of sales through our distributors (who purchase prepaid game cards at a discount to their face value) and direct sales of game points to players through our website;
- the breadth and depth of our distribution network and the corresponding availability of our prepaid game cards;
- the success of our advertising and promotional efforts;

seasonality of our sales of prepaid game cards and revenue recognition based on our game players behavior, during and around the Chinese New Year holidays in the first quarter and the National Day holidays in the fourth quarter, when fewer of our targeted players play our games;

the period of time over which we recognize revenue for some of our virtual items in our free-to-play games, which in certain cases is based on the estimated lifespan of our virtual items, which are adjusted from time to time; and

the success of our investments and merger and acquisition activities.

Reorganization of Our Game Development Studios

As a result of our game development studio reorganization in 2009 and 2010, a portion of the net income generated by games developed or supported by our game development studios will be attributable to the non controlling shareholders of the studios. We expect such reorganization will help increase our net revenues and gross margin, but our net income may be adversely affected as a result of the profit-sharing mechanism. Under such arrangement, in particular in the case of ZT Online 2 which contributed to a substantial portion of our net revenues in 2011 and is expected to be the key driver of our revenue growth in 2012. As revenues generated from ZT Online 2 continue to grow, we believe that our top line growth stimulated by this new profit-sharing mechanism will help mitigate the adverse impact resulted from the net revenues attributable to the non controlling shareholders of the game development studios.

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Key Operating Metrics

Our management uses a number of user statistics to evaluate the performance of our company, including, among others, average concurrent users, peak concurrent users, active paying users and average revenues per user. The following tables set forth the above-mentioned user statistics of our company for the periods indicated.

	December 31, 2010	March 31, 2011	June 30, 2011	September 30, 2011	December 31, 2011
		(in thousands, except average revenues per user)			
Average Concurrent Users	584	586	654	661	667
Peak Concurrent Users	1,713	1,916	2,122	2,297	2,339
Active Paying Players	1,693	1,779	1,994	2,087	2,167
Average Revenues per User (RMB)	215	216	212	217	221

Although we commercially launched ZT Online 2 in September 2011, the number of players of our ZT Online 1 series remained quite stable and therefore we did not experience any substantial decrease in our user statistics for ZT Online 1 Series. Along with the growth in our online game net revenues and the commercial launch of ZT Online 2, the number of our average concurrent users, peak concurrent users and active paying users continued to grow in 2011 on a quarterly basis. The user statistics for average concurrent users, peak concurrent users and active paying users in the fourth quarter of 2010 were 584,000, 1,713,000 and 1,693,000, respectively, as compared to 667,000, 2,339,000 and 2,167,000 in the fourth quarter of 2011, respectively. The average revenues per user, or ARPU, increased slightly from RMB215 to RMB221 (US$35.1) between the fourth quarter of 2010 to the fourth quarter of 2011 primarily as a result of the increasing popularity of ZT Online 2 after its official implement. As ZT Online 2 is still at an early stage of its lifecycle, we expect that the number of players of ZT Online 2 will continue to increase and that the ARPU for ZT Online 2 will gradually pick up, making ZT Online 2 the main growth driver of our online game net revenues in 2012.

Net revenues

Our net revenues consist of online game net revenues, licensing net revenues, and other net revenues. The following table sets forth a breakdown of our net revenues for the years indicated.

	For the Year Ended December 31,						
	2009		2010		2011		
	(RMB)	% of Net revenues	(RMB)	% of Net revenues	(RMB)	(US$)	% of Net revenues
	(in millions, except percentages)						
Net revenues:							
Online game revenues	1,293.0	99.2%	1,289.4	96.7%	1701.4	270.3	95.0%
Licensing revenues	10.7	0.8%	42.7	3.2%	54.5	8.7	3.0%
Other net revenues	0.1	%	0.7	0.1%	36.3	5.8	2.0%
Total net revenues	1,303.8	100.0%	1,332.8	100.0%	1,792.2	284.8	100.0%

Online Game Net Revenues

Online game net revenues represent revenues that we generate from operating our online games in China. Our online game net revenues are shown net of sales discounts and business taxes related to the sale of prepaid game cards and game points. Our sales discounts consist of distributor discounts, which were typically 10% of the face value of our prepaid game cards sold to distributors in 2011, and volume-related incentives, which we pay in the form of free prepaid game cards up to generally 3% and 3.5% of the volume sold by the relevant distributor.

Business taxes are generally equal to 5% of the proceeds we receive from the sale of our prepaid game cards and game points. In 2009, 2010 and 2011, our revenue was net of business tax in the amount RMB72.7 million, RMB85.0 million and RMB111.2 million (US$17.7 million), respectively, representing 5.3%, 6.0% and 6.2%, respectively, of our gross revenues in those years.

In addition to generating online game net revenues by selling our prepaid game cards through our distribution network, we also sell game points through our website. For sales made through our website, we receive the full purchase price less an online payment processing service fee that equals to 0.3% of the purchase price, which we reflect in our cost of services. In 2011, 75.2% of our sales proceeds were derived from prepaid game cards sold through our distributors, while 24.8% of our sales proceeds were derived from game point sales made through our official game website.

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Licensing Net Revenues

Licensing net revenues consist of net revenues generated from the licensing of our games to third party operators for operation both inside and outside of China. Our license agreements with third party operators generally provide for an initial license fee and a monthly revenue-based royalty fee. The initial license fee is recognized ratably over the term of the license. The royalty fees are generally equal to a fix percentage of the revenues generated by the third party operators from operating our game. In the future, we expect our licensing net revenues to increase as we continue to look for additional strategic licensing opportunities for our games for operation by third party operators in other overseas territories.

Cost of Services

Our cost of services consist of a portion of our business taxes and surcharges, compensation for employees and other personnel operating our games, computer equipment maintenance and co-location fees and internet access fees, depreciation of equipment and amortization of software and other intangible assets, and licensing fees. The following table sets forth a breakdown of our cost of services by amounts and percentages of our net revenues for the periods indicated.

	For the Year Ended December 31,						
	2009		2010		2011		
	(RMB)	% of Net revenues	(RMB)	% of Net revenues	(RMB)	(US$)	% of Net revenues
	(in millions, except percentages)						
Net revenues	1,303.8	100.0%	1,332.8	100.0%	1,792.2	284.8	100%
Cost of services:							
Sales taxes and surcharges	(39.1)	(3.0)%	(37.2)	(2.8)%	(72.8)	(11.6)	(4.1)%
Compensation	(45.4)	(3.5)%	(41.8)	(3.1)%	(51.4)	(8.2)	(2.9)%
Computer maintenance, co-location and internet access fees	(58.2)	(4.5)%	(53.8)	(4.0)%	(55.1)	(8.7)	(3.1)%
Depreciation and amortization	(49.4)	(3.8)%	(57.4)	(4.3)%	(48.4)	(7.7)	(2.7)%
Licensing fees		%		%	(19.7)	(3.1)	(1.1)%
Miscellaneous	(12.0)	(0.9)%	(8.9)	(0.7)%	(9.8)	(1.6)	(0.5)%
Total cost of services	(204.1)	(15.7)%	(199.1)	(14.9)%	(257.2)	(40.9)	14.4%

Sales Taxes and Related Surcharges

Our cost of services includes business taxes, value-added tax, or VAT, and related surcharges on technical and consulting fees and royalty fees charged by each of the Group s PRC subsidiaries, Zhengtu Information, Jujia Network, Juhuo Network and Snow Wolf Software to the Group s VIE subsidiary, Giant Network. Giant Network incurs additional business taxes and related surcharges in connection with sales of our prepaid game cards and game points. However, we present our net revenues net of these taxes and related surcharges. See Item 5. Operating and Financial Review and Prospects Income Tax Expense China.

Compensation

We account for compensation expenses for our employees that are directly involved in the operation of our online games, including our maintenance team, platform team and customer support team, as a cost of services. Compensation expenses include employee wages, share-based compensation and welfare benefits, such as social insurance, medical insurance, housing subsidies, unemployment insurance and pension benefits. We expect an increase in compensation expenses in 2012 primarily due to increases in wages and benefits.

Computer Maintenance Co-location and Internet Access Fees

Our costs associated with the maintenance of computer equipment, co-location fees and internet access fees primarily consist of co-location and internet access fees charged by third-party internet data centers from which we operate our servers. Another large component of these expenses is server maintenance costs. We typically rely on internet data centers to resolve our minor server problems, but use our own Shanghai-based maintenance team to resolve more complicated problems. In 2012, we expect our co-location and internet access fees and server maintenance costs to remain relatively stable as compared to 2011. We may, however, decide to install servers in new locations across China, which would further increase our costs.

Depreciation and Amortization

Our depreciation of equipment and amortization of software and other intangible assets relate primarily to depreciation of our servers and other computer equipment as well as capitalized product development costs. We include depreciation and amortization expenses within our cost of services when the relevant assets are directly related to the operation of our platform and provision of online games. Depreciation and amortization expenses are characterized as operating expenses in all other cases. In 2012, we expect these expenses to remain stable or decrease in connection with the development of our potential game projects.

Licensing Fees

Our cost of services did not include any third-party game licensing fees in 2009 or 2010 as all of our games in operation during those years were either self-developed or acquired. In the fourth quarter of 2011, however, we commercially launched our first licensed game, Elsword, and began recording licensing fees. Our game licensing fees consist of upfront licensing fees, which we generally pay in several installments, and ongoing royalty fees, which are generally equal to a percentage of the revenues we generate from operation of the relevant game. Upfront licensing fees are amortized on a straight-line basis over the shorter of the license period or the useful economic life of the relevant game. We expect our licensing fees to increase in 2012 as a result of the full-year effect of operating Elsword, and the potential commercial launch of Allods Online.

Operating (Expenses) Income

Operating expenses consist of research and product development expenses, sales and marketing expenses, general and administrative expenses, government financial incentives, and impairment. The following table sets forth a breakdown of our operating expenses by amount and percentage of our net revenues for the years indicated.

	For the Year Ended December 31,						
	2009		**2010**		**2011**		
	(RMB)	% of Net revenues	**(RMB)**	% of Net revenues	**(RMB)**	**(US$)**	% of Net revenues
	(in millions, except percentages)						
Net revenues	1,303.8	100.0%	1,332.8	100.0%	1,792.2	284.8	100.0%
Operating (expenses) income:							
Research and product development expenses	(113.4)	(8.7)%	(186.0)	(14.0)%	(230.2)	(36.6)	(12.8)%
Sales and marketing expenses	(119.6)	(9.2)%	(143.0)	(10.7)%	(170.0)	(27.0)	(9.5)%
General and administrative expenses	(121.4)	(9.3)%	(119.4)	(9.0)%	(103.7)	(16.5)	(5.8)%
Government financial incentives	88.5	6.8%	57.4	4.3%	47.7	7.6	2.7%
Impairment		%	(46.7)	(3.5)%			%
Total operating expenses							