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AMERICAN LEISURE HOLDINGS, INC.

Form 8-K/A

December 15, 2005

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

FORM 8-K/A
Amendment No. 1

CURRENT REPORT

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

Date of Report (Date of earliest event reported) December 13, 2005

AMERICAN LEISURE HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Nevada	333-48312	75-2877111
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(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification No.)

Park 80 Plaza East, Saddle Brook, NJ 07663

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (800) 546-9676 ext. 2076

N/A

(Former name or former address,
if changed since last report)

Check the appropriate box below if the Form 8-K is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
- Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
- Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
- Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

ITEM 1.01 ENTRY INTO A MATERIAL DEFINITIVE AGREEMENT.

On December 1, 2005, American Leisure Holdings, Inc. (the "Registrant") received from Key Bank N.A. ("Key Bank") revised terms of the loan commitments previously issued on August 15 and 16 of this year. On December 13, 2005, the Registrant consummated the loan commitment contracts with Key Bank ("KeyBank").

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The new loan commitments revise the terms for two credit facilities to be used in the development of The Sonesta Orlando Resort at Tierra del Sol, a 972 luxury, town home and condominium unit property to be located in the heart of the Orlando, Florida theme park area. The Registrant first disclosed the terms of the original commitment letters regarding the two credit facilities in a Form 8-K filed with the United States Securities and Exchange Commission (the "SEC") on August 18, 2005. The Registrant is filing this report to make its disclosure consistent with the terms of the new commitments which were finalized on December 13, 2005.

The primary change is that Key Bank has committed to fund up to \$72,550,000 with a cap on the maximum principal balance outstanding at any one time of \$40,000,000. This method of funding is called a revolving credit facility which will be more efficient for a construction project. The prior loan principal committed was 96,600,000. Phase I has also been redefined to consist of 114, rather than 250 town homes, plus 180 mid-rise condominiums. The purpose of the changes is to achieve greater economy in terms of loan costs over the full course of the development and construction of the resort. Key Bank has also reiterated its commitment to fund a second loan in the amount of \$14,850,000 as a land loan for the second phase of the resort. Both loans are expected to close before the end of 2005. The loans will be subject to various terms and conditions standard in the industry for these types of loans as generally described in the commitment letters attached hereto as Exhibits 10.3 and 10.4. The first phase has been pre-sold for \$166,000,000. Total sales to date on both phases currently total \$238,000,000. Completion of all 972 units is scheduled during 2007.

\$72,550,000 Loan Commitment

On December 13, 2005, Key Bank National Association ("Key Bank") and Tierra Del Sol Resort (Phase 1), L.P. (the "Partnership"), a special purpose development company of which a subsidiary of the Registrant is the 97% limited partner, along with nine special purpose entities that are owned by the Partnership (collectively, the "Borrowers"), entered into a contract of commitment for Key Bank to loan the Borrowers up to \$72,550,000 to construct the first phase of The Sonesta Orlando Resort at Tierra del Sol. The first phase is now scheduled to include 294 vacation units, a large swimming and recreation complex which will include a combination pool and lazy river swimming feature, an outdoor sports bar and food service area, restroom facilities, showers, water-slides, beach volleyball and extensive sundecks. The total projected cost of the first phase is \$130,463,741. Key Bank received a written appraisal from Integra Realty Resources on March 15, 2005 reflecting an appraised value of the land of \$90,700,000. The Borrowers are required to begin construction within thirty days of closing and complete the first phase within twenty-one months. Construction has already begun on the project.

The loan will be for a term of twenty-four months from the date of closing. Advances of proceeds of the loan will bear interest at the daily, floating 30-Day Daily Adjustable LIBOR Rate plus the LIBOR Rate Margin of 2.75% (as those terms are defined by the parties) subject to adjustment for any applicable reserves and taxes if required by future regulations. Interest will be due and payable monthly beginning on the fifth day of the first month following closing. In the event of default, the interest rate will be the greater of 3% in excess of the interest rate otherwise applicable on each outstanding advance or 18%. The Borrowers will be required to institute an interest rate hedging program through the purchase of an interest rate swap, cap, or other such interest rate protection product from Key Bank or any qualified banking institution.

The loan will be evidenced by a promissory note and a construction loan

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agreement. The loan will be secured by a first lien on The Sonesta Orlando Resort at Tierra del Sol, including the land, improvements, easements, and rights of way; a first lien and security interest in all fixtures and personal property, an assignment of all leases, subleases and other agreements relating to the resort; an assignment of construction documents; a collateral assignment of all contracts and agreements related to the sale of each condominium unit; a collateral assignment of all purchase deposits and any management and/or operating agreement. The Registrant, its Chief Executive Officer, Malcolm J. Wright and a Florida single purpose limited liability company to be capitalized by a loan from PCL Construction Enterprises, Inc. ("PCL") will guarantee repayment of the loan. Those parties will also guaranty performance and completion. PCL, an international construction company and parent to the company that will serve as general contractor, will guaranty completion of the resort based on a fixed price and time schedule pursuant to a construction contract. PCL will be required to pay substantial penalties if the time schedule is not met.

The Borrowers and some of the guarantors will enter into an environmental indemnity agreement. Key Bank will enter into a subordination, nondisturbance and attornment agreement with each tenant under any lease The Borrowers will pay 1% of the loan amount as a commitment fee. The Borrowers will pay \$75,000, rather than \$150,000 as originally planned, per year as a loan administration fee. The Borrowers are obligated to pay all costs and expenses of Key Bank in connection with the commitment and closing of the loan.

The Borrowers are required to maintain Project Equity in the project equal to 44% of the total cost, which must be deposited with Key Bank prior to closing or used to pay costs approved by Key Bank. The Borrowers are required to provide Key Bank with pre-construction sales contracts on 100% of the units in Phase 1 with aggregate net proceeds sufficient to cover 120% of the maximum aggregate funding of \$72,550,000. The Borrowers are required to deliver, or demonstrate to Key Bank valid expenditure of, pre-construction sales deposits of \$17,209,078 on the initial 294 units being developed in Phase 1 as part of the equity requirement otherwise the equity requirement is increased, dollar-for-dollar for each dollar that deposits are less than this amount.

Westridge Community Development District Bonds

The first phase (a CDD phase) of site work for 600 units at an estimated cost of \$19,200,000 will be funded by the Westridge Community Development District from the sale bonds issued on a non-recourse basis to the Registrant.

The district was initially created by the Registrant and enabled by an order of a Florida State District Court. The Borrowers will collaterally assign to Key Bank specified proceeds from the funding of approximately \$25,000,000 of Special Assessment Capital Improvement bonds issued by the Westridge Community Development District. Key Bank Capital Markets, an entity related to Key Bank, will underwrite the issuance of the bonds, with net proceeds in the amount of approximately \$21,500,000, of which \$8,038,370 will be used for land, \$6,038,370 will be used for costs to construct the resort, and \$2,000,000 will be placed in a collateral account to be pledged as additional security for the principal amount of the construction loan.

\$14,850,000 Loan Commitment

On December 13, 2005, the Registrant and Key Bank also revised the terms of Key Bank's committment to provide up to \$14,850,000 to be used solely for the purpose of being invested in the equity in the first phase of The Sonesta

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Orlando Resort at Tierra del Sol. The second phase is scheduled to include 678 vacation units, a 126,000 square foot clubhouse (84,000 square feet under air), additional resort amenities, including miniature golf, a flow rider water attraction, a wave pool, a rapid river and a children's multilevel interactive water park as well as additional clubhouse improvements, include the finishing, equipping and furnishing of banquet and meeting rooms, casual and fine dining restaurants, a full service spa, a sales center and an owners' club. Key Bank received a written appraisal from Integra Realty Resources on March 15, 2005 reflecting an appraised value of \$29,700,000 which satisfies Borrower's requirement to provide Key Bank with evidence that the land appreciation equity invested in the resort indicates a loan-to-value ratio of not more than 50%.

The loan will be for a term of eighteen months from the date of closing. Advances of proceeds of the loan will bear interest at the daily, adjusted 30-Day LIBOR Adjusted Daily Rate plus the LIBOR Rate Margin of 3.10% subject to adjustment for any applicable reserves and taxes if required by future regulations. Interest will be due and payable monthly beginning on the fifth day of the first month following closing. In the event of default, the interest rate will be the greater of 3% in excess of the interest rate otherwise applicable on each outstanding advance or 18%. The Borrower may elect, but will not be required to institute an interest rate hedging program through the purchase of an interest rate swap, cap, or other such interest rate protection product. The loan will be evidenced by a promissory note and a loan agreement.

The loan will be secured by a first lien on the second phase of The Sonesta Orlando Resort at Tierra Del Sol, including the second phase land, improvements, easements, and rights of way; a first lien and security interest in all fixtures and personal property, an assignment of all leases, subleases and other agreements relating to the resort; a guaranty of payment by the Registrant and its Chief Executive Officer, Malcolm J. Wright; an environmental indemnity agreement by the Borrower, the Registrant and Mr. Wright; a subordination, nondisturbance and attornment agreement relating to any leases; a collateral

assignment of security agreements and contracts related to the resort; and a collateral assignment of all purchase contracts and purchase deposits. The Borrower will pay 1% of the loan amount as a commitment fee.

The Borrower will pay an exit fee equal to 4% of the Phase 2 loan unless the loan is repaid with a construction loan from Key Bank or Key Bank declines to grant a construction loan to the Borrower. The Borrower is obligated to pay all costs and expenses of Key Bank in connection with the commitment and the closing of the loan. Construction on the second phase is expected to start during 2006 and overlap with construction on the first phase.

ITEM 9.01 FINANCIAL STATEMENTS AND EXHIBITS

(c) Exhibits.

Exhibit No.	Description
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10.1 (1)	Commitment Letter with Key Bank National Association for \$96,000,000 for Phase 1
10.2 (1)	Commitment Letter with Key Bank National Association for \$14,850,000 for Phase 2
10.3 (*)	Commitment Letter with Key Bank National Association for up to 72,550,000, with a maximum principal balance of \$40,000,000 for Phase 1 dated December 1, 2005

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10.4 (*) Commitment Letter with Key Bank National Association for up to \$14,850,000 for Phase 2 dated December 1, 2005

*Filed herein

(1) Filed as Exhibit 10.1 and 10.2, respectively to the Registrant's Form 8K filed on August 18, 2005, and incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

AMERICAN LEISURE HOLDINGS, INC.

By: /s/ Malcolm J. Wright

Malcolm J. Wright
Chief Executive Officer

Dated: December 15, 2005

dment No. 1. The balance sheet data as of December 31, 2001 and the statement of operations data for the year ended December 31, 2001 are derived from our audited financial statements and related notes thereto, which are not included in this Amendment No. 1. The balance sheet data as of December 31, 2002 are derived from our unaudited financial statements and related notes thereto, which are not included in this Amendment No. 1.

As of and for the Years Ended December 31,

	2000⁽¹⁾	2001	2002	2003	2004	2004⁽²⁾
	(Unaudited)		(Restated)	(Restated)	(Restated)	(Unaudited)
	(In millions of Won and thousands of US\$, except share and per share data, operating data and percentages)					

Statement of operations:

Revenues:						
Online games subscription revenue	₩	₩	₩	7,310	₩	18,560
Online games royalties and license fees			2,330	29,727	₩	16,253
Mobile games				43		376
Character merchandising, animation and other revenue	405	167	427	1,185	2,696	US\$ 16,732
Total revenues	405	167	10,067	49,515	64,426	66,323
Cost of revenues	336		1,738	6,958	10,116	10,414
Gross profit	69	167	8,329	42,557	54,310	55,909
Operating expenses:						
Selling, general and administrative	211	354	4,870	11,360	13,660	14,062
Research and development	208	718	815	1,597	2,029	2,089
Operating income (loss)	(350)	(905)	2,644	29,600	38,621	39,758
Other income (expense)		(3)	(2,424)	(6,210)	(4,879)	(5,023)

Income (loss) before income tax expenses, minority interest, and equity in loss of related joint venture	(350)	(908)	220	23,390	33,742	34,735
Income tax expenses			542	4,250	5,406	5,565
Income (loss) before minority interest and equity in loss of related joint venture	(350)	(908)	(322)	19,140	28,336	29,170
Minority interest					(17)	(18)
Equity in loss of related joint venture					296	305
Net income (loss)	₩ (350)	₩ (908)	₩ (322)	₩ 19,140	₩ 28,057	US\$ 28,883
Earnings (loss) per share:						
Basic and diluted per share	₩ (350)	₩ (492)	₩ (96)	₩ 3,730	₩ 5,056	US\$ 5.20
Basic and diluted per ADS						
Weighted average number of shares outstanding (basic and diluted)	1,000,000	1,846,575	3,355,616	5,130,895	5,548,900	5,548,900
Balance sheet data:						
			(Unaudited)			
Cash and cash equivalents	₩ 39	₩ 1,820	₩ 560	₩ 5,405	₩ 16,405	US\$ 16,888
Total current assets	75	2,383	7,916	17,824	46,868	48,247
Property and equipment, net	88	522	2,254	5,417	14,760	15,195
Total assets	208	3,055	13,617	36,424	68,644	70,665
Total current liabilities	38	1,123	8,251	10,575	12,221	12,581
Total liabilities	58	2,912	13,707	13,960	18,209	18,745

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	As of and for the Years Ended December 31,					
	2000⁽¹⁾	2001	2002	2003	2004	2004⁽²⁾
	(Unaudited)		(Restated)	(Restated)	(Restated)	(Unaudited)
	(In millions of Won and thousands of US\$, except share and per share data, operating data and percentages)					
Total shareholders equity	150	143	(90)	22,464	50,435	51,920
Selected operating data and financial ratios:						
Aggregate peak concurrent Ragnarok Online users ⁽³⁾			200,150	597,615	762,585	762,585
Average concurrent Ragnarok Online users ⁽⁴⁾			79,364	252,457	452,519	452,519
Gross profit margin ⁽⁵⁾	17.0%	100.0%	82.7%	85.9%	84.3%	84.3%
Operating profit margin ⁽⁶⁾	N/M	N/M	26.3	59.8	59.9	59.9
Net profit margin ⁽⁷⁾	N/M	N/M	(3.2)	38.7	43.5	43.5

N/M = not meaningful

Notes:

- (1) Reflects financial information since our inception on April 4, 2000.
- (2) For convenience, the Won amounts are expressed in U.S. dollars at the rate of ₩971.4 to US\$1.00, the noon buying rate in effect on March 31, 2006 as quoted by the Federal Reserve Bank of New York.
- (3) The number of peak concurrent users in a given period for a country in which Ragnarok Online is commercially

offered represents the highest number of users simultaneously logged on to our games servers during that period in that country. The aggregate monthly number of peak concurrent users is computed by adding the number of peak concurrent users for a given month in all of the countries in which Ragnarok Online is commercially offered. The aggregate number of peak concurrent users for any longer period represents the highest aggregate monthly peak concurrent user number within that given period. The number of peak concurrent users in a country (or in the case of Taiwan and Hong Kong, Malaysia and Singapore, or Germany, Austria, Switzerland, Italy and Turkey, in such group of countries) is determined on the basis of computer-generated data that shows the number of concurrent users for such country or group of countries, as applicable, at generally one-minute

intervals. Within a given month, due to time differences and other factors, the exact point in time at which the peak number of concurrent users is reached may differ from country to country.

- (4) The number of average concurrent Ragnarok Online users in a given period represents the sum of the average number of concurrent users for that period in Korea, Japan, Taiwan/Hong Kong, Thailand and China, the five key markets, in terms of revenue contribution from Ragnarok Online, in which it is commercially offered. The number of average concurrent users in a given period is computed by adding the monthly average number of concurrent users and dividing the total by the number of months in the same period. The monthly average number of concurrent users is computed by adding the daily average number of concurrent users during a given month and dividing the total by the actual number of

days in that month. The daily average number of concurrent users is generally computed by adding the number of concurrent users selected in three-hour intervals (for example, the number of concurrent users at 12:00 am, 3:00 am, 6:00 am, 9:00 am, 12:00 pm, 3:00 pm, 6:00 pm and 9:00 pm on a given day) and dividing it by eight. In certain limited situations, for example, when our servers are down for maintenance or updates or when our monitoring server fails to maintain connection to our game servers, the number of our concurrent users at such time will appear as zero . We have adjusted the daily average number of concurrent users to remove this information from our computation. Within a given period, due to time differences and other factors, the exact points in time used to calculate the average number of concurrent users may differ from country to country.

- (5) Gross profit margin is calculated as gross profit divided by total revenues.
- (6) Operating profit margin is calculated as operating income (loss) divided by total revenues.
- (7) Net profit margin is calculated as net income (loss) divided by total revenues.

Exchange Rates

Fluctuations in the exchange rate between the Korean Won and U.S. dollar may affect the market price of our ADSs. These fluctuations will also affect the U.S. dollar conversion by the depositary of any cash dividends paid in Korean Won and the Korean Won proceeds received by the depositary from any sale of our common shares represented by our ADSs.

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In certain parts of this Amendment No. 1, we have translated Korean Won amounts into U.S. dollars for the convenience of the investors using noon buying rates. The noon buying rate is the rate in The City of New York used for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise stated, all translations from Korean Won to U.S. dollars were made at ₩971.4 to US\$1.00, which was the noon buying rate in effect on March 31, 2006 as quoted by the Federal Reserve Bank of New York. The translation is not a representation that the Korean Won or U.S. dollar amounts referred to herein could have been or could be converted into U.S. dollars or Korean Won, as the case may be, at any particular rate, or at all. The table below sets forth, for the periods indicated, information concerning the noon buying rate for Korean Won, expressed in Won per one U.S. dollar.

Year Ended December 31,	At End of Period	Average(1) (Won per US\$1.00)	High	Low
2001	1,313.5	1,292.0	1,369.0	1,234.0
2002	1,186.3	1,250.4	1,332.0	1,160.6
2003	1,192.0	1,192.1	1,262.0	1,146.0
2004	1,035.1	1,139.3	1,195.1	1,035.1
2005	1,010.1	1,023.7	1,059.8	997.0
2006 (through May 8, 2006)	927.4	967.6	1,002.9	927.4
January	958.9	981.8	1,002.9	958.9
February	970.9	969.8	976.3	962.0
March	971.4	974.7	982.0	966.8
April	942.8	952.6	970.4	939.6

Source: Federal Reserve Bank of New York.

Note:

- (1) Annual and monthly averages are calculated using the average of the daily rates during the relevant period.

3.B. Capitalization and Indebtedness

Not applicable.

3.C. Reasons for the Offer and Use of Proceeds

Not applicable.

3.D. Risk Factors

Set forth below are certain risks and uncertainties relating to the Company's business, which have been updated in light of the Investigation and the subsequent decision to issue a restatement of the Original Financial Statements. These are not the only risks and uncertainties the Company faces. In particular, you should refer to Item 15 Controls and Procedures for information regarding certain material weaknesses in our internal controls over financial reporting. Additional risks and uncertainties not presently known to the Company or that the Company currently deems immaterial may also impair the Company's business. If any of the following risks actually occur, the Company's business, operating results or financial condition could be materially adversely affected.

Risks Relating to Recent Developments at GRAVITY

Our senior management team is required to devote a significant amount of attention to matters arising from events related to the Investigation

As of the date of this Amendment No. 1, our Chief Executive Officer, our Chief Financial Officer and all members of our Audit Committee have changed from the time of our Original Filing. Our new senior management team's ability to manage the Company's business has been and continues to be hindered by their need to spend significant time, effort and resources addressing our internal review of events related to the Investigation which led to the issuance by the Company of the Restated Financial Statements, including communicating with regulators, auditors and other external advisors, developing effective corporate governance procedures and designing and implementing effective internal control over financial reporting. In addition, certain of our senior management team and our board of directors, including all members of our Audit Committee,

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have recently joined the Company, and such members of our senior management and board of directors, by virtue of their relatively short tenure in their respective positions, may be required to expend more time and resources to undertake such efforts as they are not as familiar with our business. We cannot assure you that the demands on our senior management and directors to address such matters will not adversely affect our business, prospects, financial condition and results of operations.

Harm from continued regulatory scrutiny and securities litigation

We have received and continue to receive requests and inquiries from the SEC, National Association of Securities Dealers, Inc. (NASD), shareholders and others seeking information regarding our financial condition and results of operations, accounting and related internal controls over financial reporting and details related to the Investigation and the Restated Financial Statements. We cannot predict if such inquiries will ultimately lead to formal investigations and enforcement actions by the SEC or the NASD, or other government agencies or lead to lawsuits filed by our shareholders. If such formal investigations or enforcement actions occur or lawsuits are brought, we may be required to pay material fines, consent to injunctions on future conduct, be subject to other penalties or be required to expend time and resources on defending against such litigation, each of which could have a material adverse effect on our business, financial condition and results of operations.

Furthermore, we are currently subject to a class action lawsuit pending in the United States District Court for the Southern District of New York titled *In Re Gravity Co., Ltd. Securities Litigation* (Consolidated Civ. Act. No. 1:05-CV-4804 (LAP.)). This action combines three separate lawsuits filed in the Southern District in May, 2005, which were consolidated by an order of the Court entered on December 12, 2005. The plaintiffs seek to represent a class of persons who purchased our ADSs in the open market between February 7, 2005 and May 12, 2005. Each of the complaints alleged violations of the Securities Act of 1933 and the Exchange Act of 1934 against us and the former individual directors and officers. The claims arise out of an initial public offering of our ADSs in the United States beginning February 7, 2005. Plaintiffs allege that, in connection with the public offering of the ADSs, we misstated or omitted material information relating to various aspects of our business, including an alleged decline in sales of our core online product, and material adverse trends affecting our mobile animation business and Chinese operations. Plaintiffs seek, for themselves and the class members, compensatory damages, fees and expenses and other unspecified relief. Following the consolidation of the actions, a Stipulation and Order was entered by the Court in which, among other things, it provided for the filing of a single consolidated amended complaint by the later of February 28, 2006 or 45 days after we announce a restatement of our previously issued financial statements. As of the date of this Amendment No. 1, the consolidated amended complaint has not yet been filed or served. We cannot at this time determine what the final conclusion of such litigation will be, including any damages which may need to be paid or any amounts which may be paid in settlement. A judgment against us in such litigation may result in significant damages. Also, any settlement amounts, if we were to agree to settle, may be significant and may have a material adverse affect on our financial condition, results of operations and liquidity.

Risks related to our business***We currently depend on one product, Ragnarok Online, for substantially all of our revenues.***

Substantially all of our revenues are currently derived from a single product, Ragnarok Online. In 2004, we derived approximately 95.2% of our revenues from Ragnarok Online. We expect to continue to derive a substantial majority of our revenues from Ragnarok Online through at least 2005. Failure by us to maintain, improve, update or enhance Ragnarok Online in a timely manner or successfully enter new markets could reduce Ragnarok Online's user base, decrease its popularity, or reduce revenues generated from it and materially and adversely affect our business, financial condition and results of operations.

We depend on license fees and royalty payments from our overseas licensees for a substantial portion of our revenues.

In markets other than Korea, the United States and Canada, we license Ragnarok Online to overseas operators or distributors from whom we receive license fees and royalty payments based on a percentage of such operators revenues from Ragnarok Online pursuant to license arrangements. Such overseas license fees and royalty payments represented 70.0% of our revenues in 2004. In 2004, we derived 28.5% of our total revenues from GungHo Online Entertainment Inc., our licensee in Japan, and 22.7% of our total revenues from Soft-World International Corporation,

our licensee in Taiwan. Deterioration in financial condition or adverse developments in the results of operations of our overseas licensees may materially and adversely affect our business, financial conditions and results of operations.

In many of our markets, we rely heavily on our overseas licensees to operate and distribute our games.

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We rely on our overseas licensees for substantially all aspects of our overseas operations, including:
holding the required government licenses for the operation and distribution of our games,

publishing, advertising and marketing our games,

establishing the pricing of our games after consultation with us,

owning and operating the server network and other aspects of game management and maintenance,

providing customer service and trouble-shooting,

maintaining network security and providing back-up for game data and software, and

billing and collecting subscription fees from users and remitting royalty payments to us.

Under the license arrangements, our overseas licensees may operate or publish other online games developed or offered by our competitors. Therefore, our overseas licensees may devote greater time and resources to marketing their proprietary games or those of our competitors than to ours.

Our overseas licensees are responsible for complying with local laws, including obtaining and maintaining the requisite government licenses and permits. Failure by our overseas licensees to do so may have a material adverse effect on our business, financial condition and results of operations.

Our overseas licensees are responsible for remitting royalty payments to us based on a percentage of sales from our games, after deducting certain expenses. We generally are advised by each of our licensees as to the amount of royalties earned by us from such licensee within 30 to 45 days following the end of each month. Online payment systems in China and certain other countries are still in a developmental stage and are not as widely available or used. Payment for online game services in these countries typically take the form of prepaid cards sold in Internet cafés, convenience stores and other distribution channels. Some of our overseas licensees rely heavily on a multilayer distribution and payment network composed of third party distributors for sales to, and collection of payments from, users. Failure by our licensees to maintain a stable and efficient billing, recording, distribution and payment collection network in these markets may result in inaccurate recording of sales or insufficient collection of payments from these markets and may materially and adversely affect our financial condition and results of operations.

Our reliance on third parties that we do not control exposes us to certain risks that we would not encounter if we were to operate or distribute directly in such markets. If our overseas licensees fail to perform their contractual obligations or suffer from management or other problems in their businesses, our business operations in overseas markets and our ability to collect royalty payments from such markets may be materially and adversely affected. We may not be able to easily terminate our license agreements with our overseas licensees as these agreements do not specify particular financial or performance criteria that need to be met by our licensees. As our overseas licensees generally have the exclusive right to distribute our games in their respective markets typically for a term of two years, we may not be able to enter into a new license agreement in a particular country for the term of the agreement unless it is terminated earlier. In general, we may not unilaterally terminate our license agreements.

If we are unable to consistently develop, acquire, license, launch, market or operate commercially successful online games in addition to Ragnarok Online, our business, financial condition and results of operations may be materially and adversely affected.

In order to maintain our growth and profitability, we must continually develop or publish commercially successful new online games in addition to Ragnarok Online that will retain our existing users and attract new users. To date, we have acquired a controlling interest of a third party developer that develops R.O.S.E, from whom we used to have an exclusive license to distribute R.O.S.E. Online and are internally developing Requiem and Ragnarok Online 2, a sequel to Ragnarok Online. A game's commercial success largely depends on appealing to the tastes and preferences of a critical mass of users as well as the willingness of such users to continue as paying subscribers after the completion of the free open beta testing stage, all of which are difficult to predict prior to a game's development and introduction.

Developing games internally requires substantial development costs, including the costs of employing skilled developers and acquiring or developing game engines which enable the creation of products with the latest technological features. In order to succeed, we must acquire, license or

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develop promising games at an acceptable cost and ensure technical support for the successful operation of such games. The online game publishing market is highly competitive and we may not be able to acquire or license promising games at an acceptable cost. In order to successfully distribute and operate a game, we also need a sizable game management and support staff, continued investment in technology and a substantial marketing budget. We cannot assure you that the games we develop or publish will be attractive to users or otherwise be commercially successful, launched as scheduled or able to successfully compete with games operated by our competitors. If we are not able to consistently develop, acquire, license, launch, market or operate commercially successful online games, we may not be able to generate enough revenues to offset our initial development, acquisition, licensing or marketing costs, and our future business, financial condition and results of operations will be materially and adversely affected.

We operate in a highly competitive industry and compete against many large companies.

There are many companies in the world, including over 100 companies in Korea alone, that are dedicated to developing and/or operating online games. We expect more companies to enter the online game industry and a wider range of online games to be introduced in our current and future markets. Our competitors in the massively multiplayer online role playing game industry vary in size from small companies to very large companies with dominant markets shares such as NCsoft and Shanda. We also compete with online casual game and game portal companies such as NHN, Nexon and CJ Internet. In addition, we may face stronger competition from console game companies, such as Sony, Microsoft, Electronic Arts, Nintendo and Sega, many of which have announced their intention to expand their game services and offerings over broadband Internet. Many of our competitors have significantly greater financial, marketing and game development resources than we have. As a result, we may not be able to devote adequate resources to develop, acquire or license new games, undertake extensive marketing campaigns, adopt aggressive pricing policies or adequately compensate our or third-party game developers to the same degree as certain of our competitors.

As the online game industry in many of our markets is relatively new and rapidly evolving, our current or future competitors may compete more successfully as the industry matures. In particular, any of our competitors may offer products and services that have significant performance, price, creativity or other advantages over those offered by us. These products and services may weaken the market strength of our brand name and achieve greater market acceptance than ours. In addition, any of our current or future competitors may be acquired by, receive investments from or enter into other strategic relationships with larger, longer-established and better-financed companies and therefore obtain significantly greater financial, marketing and game licensing and development resources than we have. Increased competition in the online game industry in our markets could make it difficult for us to retain existing users and attract new users, and could reduce the number of hours users spend playing our current or future games or cause us and our licensees to reduce the fees charged to play our current or future games. In some of the countries in which our games are distributed, such as Korea and Taiwan, growth of the market for online games has slowed while competition continues to be strong. If we are unable to compete effectively in our principal markets, our business, financial condition and results of operations could be materially and adversely affected.

We have a limited operating history, which may make it difficult for you to evaluate our business.

We have a limited operating history upon which you can evaluate our business and prospects. Our business was established in April 2000 but Ragnarok Online was commercially introduced in August 2002. Our senior management and employees have worked together at our company for a relatively short period of time, including as a result of frequent changes in senior management to date. In addition, the online game industry, from which we derive substantially all of our revenues, is a relatively new industry. The first massively multiplayer online role playing game in Korea was developed and distributed by one of our competitors in 1996. Since then, only a limited number of companies have successfully commercialized such online games on an international scale. You must consider our business prospects in light of the risks and difficulties we will encounter as an early-stage company in a new and rapidly evolving industry. We may not be able to successfully address these risks and difficulties, which could materially harm our business, financial condition and results of operations.

Rapid technological change may adversely affect our future revenues and profitability.

The online game industry is subject to rapid technological change in areas including hardware, software and content programming. We need to anticipate the emergence of new technologies and games, assess their likely market

acceptance, and make substantial game development and related investments. In addition, new technologies in online game programming or operations could render our current or future games obsolete or unattractive to our subscribers, thereby limiting our ability to recover game-related development, acquisition or licensing costs and potentially materially and adversely affecting our business, financial condition and results of operations.

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If we fail to retain and hire skilled and experienced game developers or other key personnel in order to design and develop new online games and additional game features, we may be unable to achieve our business objectives.

In order to meet our business objectives and maintain our competitiveness in the future, we will need to continue to attract and retain skilled and experienced online game developers and other key personnel. We rely on the collective efforts of our game development teams led by the following officers: (i) for Ragnarok Online, Sang Gil Hong, Myung Shin Lee, Jae Woo Ahn, Min Soo Lee, and Dae Hee Chung, (ii) for Ragnarok Online II, Young Woo Park, Jae Chong Rhee, Seung Yoon Woo, Jeong Beom Seo, and Jea Jin Yoo, (iii) for Requiem, Sang Jin Yoon, Myong Park Jung, Yeung Hoon Cha, Chan Gu Jung, and Ja Hwan Gu, and (iv) for overall art direction and graphics of all of our games, Joon Ho Jeong and Myoung-Jin Lee. While certain of our current senior technical officers or staff members are bound by non-competition agreements for six months after termination of employment with us, since our industry is characterized by high demand and intense competition for talent, we may need to offer higher compensation and other benefits in order to retain or replace key personnel. Since our inception in April 2000, our chief executive officer has changed on five occasions and several other executive officers have also changed. In addition, as we are still a relatively young company and our business has grown rapidly since our establishment, at times our ability to train and integrate new employees into our operations may not meet the growing demands of our business.

Undetected programming errors or flaws in our games could harm our reputation or decrease market acceptance of our games, which would materially and adversely affect our results of operations.

Our current and future games may contain errors or flaws, which may become apparent only after their release. In addition, our online games are developed using programs and engines developed by and licensed from third party vendors, which may include programming errors or flaws over which we have no control. If our users have a negative experience with our games related to or caused by undetected programming errors or flaws, they may be less inclined to continue or resume subscriptions for our games or recommend our games to other potential users. Undetected programming errors and game defects can also harm our reputation, cause our users to cease playing our games, divert our resources or delay market acceptance of our games, any of which could materially and adversely affect our business, financial condition and results of operations.

Unexpected network interruptions, security breaches or computer virus attacks could harm our business.

Any failure to maintain satisfactory performance, reliability, security and availability of our network infrastructure, whether maintained by us or by our overseas licensees, may cause significant harm to our reputation and our ability to attract and maintain users. Major risks relating to our network infrastructure include:

any breakdowns or system failures, including from fire, flood, earthquake, typhoon or other natural disasters, power loss or telecommunications failure, resulting in a sustained shutdown of all or a material portion of our servers;

any disruption or failure in the national or international backbone telecommunications network, which would prevent users in certain countries in which our games are distributed from logging onto or playing our games for which the game servers are all located in other countries; and

any security breach caused by hacking, loss or corruption of data or malfunctions of software, hardware or other computer equipment, and the inadvertent transmission of computer viruses.

From time to time, we detect users that gain an unfair advantage by modifying Ragnarok Online execution files saved on the users' computers to facilitate progression of game characters. Unauthorized character manipulation may negatively impact the image and users' perception of Ragnarok Online and could limit our growth. In addition, the number of Ragnarok Online users may be reduced since the deletion of unauthorized character enhancements requires the affected users to restart with a new character at the beginner level and may cause them to cease playing Ragnarok Online.

Any of the foregoing factors that could interrupt the availability of our games or deteriorate the actual or perceived quality of access to our games, which could reduce our users' satisfaction and harm our business.

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

We regard our copyrights, service marks, trademarks, trade secrets and other intellectual property as critical to our

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success. Unauthorized use of the intellectual property used in our business, whether owned by us or licensed to us, may materially and adversely affect our business and reputation.

We rely on trademark and copyright law, trade secret protection and confidentiality agreements with our employees, customers, business partners and others to protect our intellectual property rights. Despite our precautions, it may be possible for third parties to obtain and use our intellectual property without authorization. For example, in April 2003 we discovered that the server-end software of Ragnarok Online was unlawfully released into Korea, China and the United States. The software piracy enabled unauthorized third parties to set up local server networks to operate Ragnarok Online, which may have resulted in a diversion of a significant number of paying subscribers. Since then, we have designated certain employees to be responsible for detecting these illegal servers and reporting them to the relevant enforcement authority in Korea in charge of crimes on the Internet. In overseas markets, we cooperate with and rely on our overseas licensees to seek enforcement actions against operators of illegal free servers. We may incur considerable costs in the future to remedy software piracy and to enforce our rights against the operators of unauthorized server networks.

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

We may be subject to future intellectual property rights claims, which could result in substantial costs and diversion of our financial and management resources.

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

Certain of our employees were recruited from other online game developers, including certain of our current or potential competitors. To the extent these employees have been and are involved in the development of our games similar to the development in which they have been involved at their former employers, we may become subject to claims that such employees or we have improperly used or disclosed trade secrets or other proprietary information. Although we are not aware of any pending or threatened claims of this type, if any such claims were to arise in the future, litigation or other dispute resolution procedures might be necessary to retain our ability to offer our current and future games, which could result in substantial costs and diversion of our financial and management resources.

The discontinuation of any of the preferential tax treatments currently available to us in Korea could materially and adversely affect our business, financial condition and results of operations.

Under Korean law and regulations, a small- and medium-sized venture company may be entitled to enjoy a preferential tax treatment from the Korean government in the form of a 50% reduction in corporate income tax rates for the year in which it first generates taxable income and the following five years if such company satisfies a number of financial and non-financial criteria, including the maintenance of its status as a designated venture company. In 2003, when we first generated taxable income, we qualified for the preferential tax treatment and enjoyed the 50% reduction in corporate income tax rates. In 2004, we also qualified for this preferential treatment and our applicable corporate income tax rate (including resident surtax) was 14.85% after the 50% reduction. A company that engages in data processing or computer related businesses, including us, may qualify as a small- and medium-sized enterprise under the Framework Act on Small- and Medium-Sized Enterprises if, among other things, (i) we hire less than three hundred full-time employees or (ii) our total revenue does not exceed ₩30 billion (US\$31 million). In 2004, we failed to satisfy both of these tests. However, even if a company fails to satisfy both of the preceding requirements, it will

continue to enjoy its status as a small- and medium-sized enterprise for the following three years so long as that company neither (x) merges into, nor consolidates with, another company nor (y) becomes an affiliate of certain large enterprises. Accordingly, we will continue to qualify as a small- and medium-sized company through 2007 if we do neither of those things. However, after 2004, we may not be able to qualify for the preferential tax treatment because our status as a designated venture company is subject to renewal in 2005 and there is no

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guarantee that we will so qualify based on the non-financial criteria, which involve a relatively subjective determination by the regulatory authority as to whether we possess a superior innovative technological ability. A designated venture company, including us, must qualify every two years based on the evaluation described above. Accordingly, our tax rate may increase substantially. The discontinuation of this preferential tax treatment could materially and adversely affect our net income. See Item 5.A. Operating Results Overview Income tax expenses. ***Our limited resources may affect our ability to manage our growth.***

Our growth to date has placed, and the anticipated further expansion of our operations will continue to place, a significant strain on our management, systems and resources. In addition to training and managing our workforce, we will need to continue to develop and improve our financial and management controls as well as our reporting systems and procedures, which will especially be the case since we have become a public company after our initial public offering in February 2005. We cannot assure you that we will be able to efficiently or effectively manage the growth of our operations, and any failure to do so may limit our future growth and materially and adversely affect our business, financial condition and results of operations.

We may not be able to successfully implement our growth strategies.

We are pursuing a number of growth strategies, including the following:

distributing games developed in-house,

publishing games acquired from third parties or developed by third parties through licensing arrangements,

offering our games in countries where we currently have little or no presence,

expanding into games offered over other platforms, such as game consoles,

taking advantage of our popular online games to strengthen our other lines of businesses, such as mobile games, animation and character merchandising, and

selectively pursuing acquisitions of, investments in, or joint ventures with, game development companies, technologies and personnel that are complementary to our existing business if the opportunity arises.

We cannot assure you that we will be successful in any of these strategies. Some of these strategies relate to new services or products for which there are no established markets, or in which we lack experience and expertise. Our growth potential in many of the markets in which Ragnarok Online is currently distributed or which we intend to enter may be limited since the penetration rate for personal computers is relatively low and the cost of Internet access relative to the per capita income is higher in such markets when compared to some of our principal markets such as Korea and Japan. If we decide to pursue acquisitions, investments or joint ventures to achieve growth, the success of such acquisitions, investments or joint ventures will depend on the availability of suitable acquisition and investment candidates at an acceptable cost, our ability to compete effectively to attract and reach agreement with acquisition candidates or joint venture partners on commercially reasonable terms, and the availability of financing to complete such acquisitions, joint ventures or investments. In certain cases, we may have liabilities that exceed the percentage of our investments, including our interest in a joint venture and may be bound by the decisions of our joint venture partners or other controlling shareholders of our investee companies that we do not necessarily agree with. We cannot be certain that any particular acquisition, investment or joint venture will produce the intended benefits on a timely basis or at all. For example, in May 2003, we invested ₩1 billion in cash in an online game portal business. Due to poor performance by the investee company, we sought to nullify the investment arrangement in December 2003 and recovered ₩223 million in cash and recorded the remaining ₩777 million as an impairment loss. In addition, we may not be able to renew licenses from our licensors at an acceptable cost in a timely manner or at all or obtain from the licensors the technical support necessary for the satisfactory operation of these games. If we are unable to successfully implement our growth strategies, our revenues, profitability and competitiveness may be materially and adversely affected.

We have limited business insurance coverage in Korea.

The insurance industry in Korea is still at an early stage of development. In particular, Korean insurance companies offer limited business insurance products. As a result, we do not have any business liability or disruption insurance coverage for our operations in Korea. In 2003 and 2004, we derived 33.3% and 21.0% of our total revenues from Korea, respectively. Any

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business disruption, litigation or natural disaster might result in our incurring substantial costs and the diversion of our resources.

We may be required to take significant actions that are contrary to our business objectives in order to avoid being deemed an investment company as defined under the Investment Company Act of 1940, as amended.

Generally, the Investment Company Act provides that a company is not an investment company and is not required to register under the Investment Company Act as an investment company if:

the company is primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities, and

40% or less of the fair market value of the company's assets is represented by investment securities.

We believe that we are engaged primarily and directly in the businesses of providing online game services, that less than 40% of the fair market value of our assets is represented by investment securities and, consequently, that we are not an investment company as that term is defined under the Investment Company Act. However, in the future we may be required to take actions to avoid the requirement to register as an investment company, such as shifting a significant portion of our long- and short-term investment portfolio into low-yielding bank deposits or other short-term securities which are not considered to be investment securities due to their liquidity and certain other characteristics. These types of investments may reduce the amount of interest on other income that we could otherwise generate from our investment activities. In addition, we may need to acquire additional income or loss generating assets that we might not otherwise have acquired or forego opportunities to acquire minority interests in companies that could be important to our strategy.

The Investment Company Act also contains regulations with respect to investment companies, including restrictions on their capital structure, operations, transactions with affiliates and other matters which would be incompatible with our operations. If we were to be deemed an investment company in the future, we would, among other things, effectively be precluded from making public offerings in the United States. We could also be subject to administrative or legal proceedings and, among other things, contracts to which we are a party might be rendered unenforceable or subject to rescission.

We may be considered a passive foreign investment company, which could lead to additional taxes for you.

Based upon the nature of our business activities, we may be classified as a passive foreign investment company, or PFIC, by the United States Internal Revenue Service, or IRS, for U.S. federal income tax purposes. Such characterization could result in adverse U.S. tax consequences to you if you are a U.S. investor. For example, if we are a PFIC, our U.S. investors will become subject to increased tax liabilities under U.S. tax law and regulations and will become subject to burdensome reporting requirements. The determination of whether or not we are a PFIC is made on an annual basis and will depend on the composition of our income and assets from time to time. Specifically for any taxable year, we will be classified as a PFIC for U.S. tax purposes if either (i) 75% or more of our gross income in the taxable year is passive income or (ii) the average percentage of our assets by value in the taxable year which produce or are held for the production of passive income (which includes cash) is at least 50%. The calculation of the value of our assets will be based, in part, on the then market value of our common shares or ADSs, which is subject to change. In addition, the composition of our income and assets will be affected by how, and how quickly, we spend the cash we raised in our initial public offering in February 2005. Based on the projected composition of our income and valuation of our assets, including goodwill, we do not expect to be a PFIC in 2005, or believe that we were a PFIC in 2004, and we do not expect to become one in the future. However, the determination of whether we are a PFIC is made annually and it is possible that we may become a PFIC in 2005 or any future taxable year due to changes in our asset or income composition. If we are a PFIC for any taxable year during which you hold our ADSs or shares, you could be subject to adverse U.S. tax consequences. See Item 10.E. Taxation U.S. federal income and estate tax considerations Passive foreign investment companies .

We and our auditors have identified certain material weaknesses in our internal controls and if we fail to achieve and maintain an effective system of internal controls, we may be unable to accurately report our financial results or reduce our ability to prevent or detect fraud, and investor confidence and the market price of our ADSs may be adversely affected.

Prior to our initial public offering in the United States, we were a non-public company incorporated in Korea and thus have traditionally reported our financial statements under Korean GAAP. As a result, we were subject only to minimum corporate governance and reporting standards applicable to unlisted companies in Korea. In the process of converting from a non-public company in Korea to a public company in the US, we have discovered areas of our internal controls and reporting

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that need improvement. As examples, our expertise in U.S. GAAP reporting is limited and our current enterprise accounting system is configured to report financial results in Korean GAAP and has not yet been customized to support U.S. GAAP reporting. As a result, in connection with the preparation of financial statements under U.S. GAAP, we have used external consultants to assist us in the preparation of financial statements and have had to use certain manual procedures in preparing our financial statements. In connection with their audit of our financial statements prepared under U.S. GAAP, our independent registered public accountants identified certain material weaknesses (as defined under standards established by the Public Company Accounting Oversight Board) in our finance team's ability to support the financial reporting requirements of a U.S. registrant. As a result of, among other things, the complexity of our business and the related accounting effects, the significant growth in our business and shortage in staffing of qualified accounting personnel, our independent accountants have specifically referenced the following areas:

our knowledge of general accounting and specific U.S. GAAP issues and our lack of internal accounting resources and reliance on external resources for accounting, U.S. GAAP, advice and bookkeeping support; and

our reliance on spreadsheet programs, which are generally more prone to errors due to the absence of effective controls over such spreadsheet access and use, to perform consolidation and prepare U.S. GAAP financial statements.

Our management and audit committee are currently executing plans to improve the identified weaknesses in internal controls through efforts to hire personnel with appropriate levels of U.S. GAAP experience and accounting expertise and engaging outside resources to upgrade our enterprise reporting system to support U.S. GAAP reporting. However, we cannot be certain that these measures will ensure that we implement and maintain adequate controls over our financial processes and reporting in the future. As we are now subject to the reporting and other obligations under U.S. federal securities laws, including the Sarbanes-Oxley Act of 2002, we are subject to more stringent obligations than those applicable to unlisted companies in Korea. If we fail to create an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud, and investor confidence and the market price of our ADSs may be adversely affected.

Risks related to our regulatory environment

Our operations are subject to the regulation of the Internet in certain of the countries in which our games are distributed, such as Korea, China, Taiwan, Japan and Thailand, the impact of which is difficult to predict.

The regulatory and legal regimes in nearly all of the countries in which our games are distributed have yet to establish a sophisticated set of laws, rules or regulations designed to regulate, among other things, the social, political and financial risks relating to the online game industry. However, in many of our key markets, such as Korea, China, Taiwan and Thailand, the legislators and regulators have, either through public announcements or press releases, indicated their intention to implement laws, rules or regulations regulating and restricting this industry, which include laws or regulations relating to issues such as user privacy, defamation, pricing, advertising, taxation, promotions, financial market regulation, consumer protection, content regulation, quality of products and services, and intellectual property ownership and infringement that may directly or indirectly impact our activities. In some of these countries, distribution of information over the Internet and electronic commerce are currently under legal and regulatory review. Other countries in which our games are distributed or which we intend to enter may adopt similar laws and regulations. The impact of such laws and regulations on our business and results of operations is difficult to predict. However, as we might unintentionally violate such laws or such laws may be modified and new laws may be enacted in the future, any such developments, or developments stemming from enactment or modification of other laws, could increase the costs of regulatory compliance, force changes in business practices or otherwise have a material adverse effect on our business and results of operations.

Our online games may be subject to governmental restrictions or rating systems, which could delay or prohibit the release of new games or reduce the existing and potential range of our user base.

Legislation is periodically introduced in many of the countries in which our games are distributed to establish a system for protecting consumers from the influence of graphic violence and sexually explicit materials contained in various types of games. For instance, Korean law requires online game companies to obtain rating classifications and

implement procedures to restrict the distribution of online games to certain age groups. Similar mandatory rating systems and other regulations affecting the content and distribution of our games have also been adopted or are under review in Taiwan, China, the United States and other markets for our online games. In Thailand, the Thai government has strengthened regulations by setting restricted hours for children under 18 years of age and may introduce additional measures for regulating online game operators. For example, a government minister recently announced a plan to impose additional taxes on online game operators. In the future, we may be required to modify our games or alter our marketing strategies to comply with new governmental regulations or new ratings assigned to our current or future games that may call for restrictions or modifications

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to our game content or features, which could delay or prohibit the release of new games or upgrades and reduce the existing and potential range of our user base. Moreover, uncertainties regarding governmental restrictions or rating systems applicable to our business could give rise to market confusion, thereby materially and adversely affecting our business.

The legal systems in some of the countries where our games are distributed have uncertainties which could limit the legal protections available to us.

The laws, regulations and legal requirements in many of the countries in which our games are distributed are constantly changing, and their interpretation and enforcement involve uncertainties. These uncertainties could limit the legal protections available to us. We cannot predict the effect of future developments in the legal systems in these countries, particularly with regard to the Internet, 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. If the cost of regulatory compliance increases for our licensees as a result of regulatory changes, our licensees may in the future seek to reduce royalties and license fees, which may materially and adversely affect our licensee's business and our results of operations and financial condition.

If the ROC Consumer Protection Commission imposes additional regulatory burdens on our licensee in Taiwan, our licensee in Taiwan may require us to reduce the license fee or royalties, or share the cost of regulatory compliance.

In 2003 and 2004, we derived 24.2% and 22.7% of our total revenues from our licensee in Taiwan. As a result of increasing disputes between the online game companies and consumers in Taiwan, the ROC Consumer Protection Commission of the Executive Yuan may promulgate certain standard provisions that must be included in a consumer contract that online game companies must use in order to operate or a model consumer contract that online game companies are encouraged to adopt. If these standard provisions or model consumer contract are implemented, the cost of regulatory compliance may significantly increase for our Taiwanese licensee. Our Taiwanese licensee may in the future seek to reduce royalties and license fees, which may materially and adversely affect our licensee's business and our results of operations and financial condition.

Our business may be adversely affected by complexities, uncertainties and changes in law and regulations of China regulating Internet companies and businesses operating in China, including those related to online games.

In 2003 and 2004, we derived 4.2% and 4.4% of our total revenues from our licensee in China. The Chinese government, through various regulatory authorities, heavily regulates the Internet sector, which includes the online game industry. These laws and regulations include the following:

restrictions on content on the Internet, including restriction on distribution of online games containing content that purports to propagate obscenity, gambling or violence, instigate crime, undermine public morality or the cultural traditions of China, or compromise state security or secrets;

license and permit requirements for companies in the Internet industry, including for importing and operating online games, from various regulatory authorities; and

restrictions on and supervision of Internet cafés, including closing of unlicensed Internet cafés and requiring installation of security software to prevent access to subversive sites.

In addition, there are uncertainties in the interpretation and application of existing Chinese laws, regulations and policies regarding the businesses and activities of Internet companies and businesses in China, including those related to our online games. Any violations of the foregoing laws and regulations as well as other laws and regulations to be introduced in the future could materially and adversely affect the business and results of operations of our Chinese licensee and us.

Restrictions on currency exchange in certain of the countries in which our games are distributed may limit our ability to receive and remit revenues effectively.

The governments in certain countries, including Taiwan, Thailand and China, in which our games are distributed, impose controls on the convertibility of the local currency into foreign currencies and, in some cases, the remittance of currency outside of their countries. Under current foreign exchange control regulations, shortages in the availability of

foreign currency may restrict the ability of our overseas licensees to pay license fees and royalties to us in U.S. dollars. Restrictions on our ability to receive license fees, royalties and other payments from our overseas licensees would adversely affect our financial condition and liquidity.

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Restrictions on currency exchange in Korea in certain emergency circumstances may limit our ability to utilize effectively revenues generated in the Korean Won to fund our business activities outside Korea or expenditures denominated in foreign currencies.

The existing and any future restrictions on currency exchange in Korea, including Korean exchange control regulations, may restrict our ability to convert the Korean Won into foreign currencies under certain emergency circumstances, such as an outbreak of natural calamities, wars, conflict of arms or grave and sudden changes in domestic or foreign economic circumstances, difficulties in Korea's international balance of payments and international finance and obstacles in carrying out currency policies, exchange rate policies and other macroeconomic policies of Korea. Such restrictions may limit our ability to utilize effectively revenues generated in the Korean Won to fund our business activities outside Korea or expenditures denominated in foreign currencies.

Adverse changes in the withholding tax rates in the countries from which we receive license fees and royalties could adversely affect our net income.

To the extent we derive revenues from countries other than Korea, we may be subject to income withholding in those countries. Income tax expenses include such withholding taxes. Withholding of such taxes is done by our overseas licensees at the current withholding rates in such countries. To the extent Korea has a tax treaty with any such country, the withholding rate prescribed by such tax treaty may apply. Under the Corporation Tax Law of Korea, we are entitled to, and recognize, a tax credit computed based on the amount of income withheld overseas when filing our income tax return in Korea, up to a limited amount. Accordingly, the amount of taxes withheld overseas may be offset against tax payable in Korea. Adverse changes in tax treaties between Korea and the countries from which we receive license fees and royalties, in the rate of withholding tax in the countries in which our games are distributed or in Korean tax law enabling us to recognize tax credits for taxes withheld overseas could adversely affect our net income.

Risks related to our market environment

Our businesses may be adversely affected by developments affecting the economies of the countries in which our games are distributed.

Our future performance will depend in large part on the future economic growth of our key markets. Adverse developments in such markets may have an adverse effect on the number of our subscribers and results of operations, which could have a material adverse effect on our business.

A deterioration in the economies of the countries in which our games are distributed can also occur as a result of a deterioration in global economic conditions. The worldwide economy has experienced periods of economic weakness since the beginning of 2001, which has been exacerbated by the terrorist attacks in the United States on September 11, 2001, recent developments in the Middle East, including the war in Iraq and terrorist attacks and threats across the globe (including Korea), rising oil prices and the economic impact of Severe Acute Respiratory Syndrome, or SARS, a highly contagious form of atypical pneumonia. In addition, if investors perceive that there is a crisis in the region, such as due to SARS or economic difficulties similar to those that Asian economies experienced in the late 1990s, companies and economies in that region may be adversely effected irrespective of their economic soundness.

Any future deterioration in global economic conditions, or a significant adverse change in politics and economies in Asia or a loss of investor confidence in the financial systems of emerging and other markets could have a material adverse effect on our business, financial condition and results of operations.

Fluctuations in exchange rates could result in foreign currency exchange losses.

In 2004, approximately 79.0% of our revenues were denominated in foreign currencies, primarily in the U.S. dollar and the Japanese Yen. In most of the countries in which our games are distributed, other than the United States, Japan and Europe, the revenues generated by our licensees in those markets are denominated in local currencies, which include the NT dollar, the Baht and the Renminbi. Depreciation of these local currencies against the U.S. dollar will result in reduced license fees and monthly royalty payments in U.S. dollar terms and may materially and adversely affect our financial condition and results of operations.

While we receive our monthly royalty revenues from our overseas licensees in foreign currencies, primarily the U.S. dollar, the Japanese Yen and the Euro, substantially all of our costs are denominated in the Korean Won. Our financial statements are also prepared and presented in the Korean Won. We receive monthly royalty payments from

our overseas

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licensees based on a percentage of revenues confirmed and recorded at the end of each month applying the foreign exchange rate applicable on such date. We generally receive these royalty payments 20 to 30 days after such record date (except in Europe, where such payments are received up to 45 days after the record date). Appreciation of the Korean Won against these foreign currencies during this period will result in foreign currency losses that may materially and adversely affect our financial condition and results of operations.

To date, we have not engaged in any foreign currency hedging activities to reduce our exposure to exchange rate fluctuations. We may enter into hedging transactions in the future to mitigate our exposure to foreign currency exchange risks, but we may not be able to do so in a timely or cost-effective manner or at all.

Risks related to specific countries in which our products are distributed

We are incorporated and headquartered in Korea, and derived 21.0% of our revenues in 2004 from our operations in Korea. In addition, in 2004, we derived an aggregate of 64.2% of our revenues from Japan, Taiwan, Thailand and China. Accordingly, our business, financial condition, results of operations and prospects are subject, to a significant extent, to economic, political, legal and regulatory conditions and developments in these countries.

Slow growth or contractions in the Internet café industry in Korea may affect our ability to target a core group of potential users.

According to the 2004 report issued by the Korean Game Development and Promotion Institute, or KGDI, the number of active Internet cafés in Korea has declined since 2002. Intensifying competition and more widespread availability of personal computers, or PCs, in homes in Korea could trigger further declines in the number of Internet cafés. Future reductions in the number of Internet cafés operating in Korea could adversely affect our ability to target a core group of potential users.

Increased tensions with North Korea could adversely affect us.

Relations between Korea and North Korea have been tense over most of Korea's modern history. The level of tension between Korea and North Korea has fluctuated and may increase or change abruptly as a result of current and future events, including ongoing contacts at the highest levels of the governments of Korea and North Korea. The level of tension between Korea and North Korea, as well as between North Korea and the United States, has increased as a result of North Korea's admission in October 2002 to the maintenance of a nuclear weapons program in breach of the peace accord executed in October 1994. In response, the United States, Japan, Korea and the European Union (which became party to the 1994 accord in November 2002) decided to suspend shipments of oil to North Korea called for by the 1994 accord and reiterated their demands for the dismantling of North Korea's nuclear weapons program. Following the suspension of oil shipments, North Korea removed the seals and surveillance equipment from its Yongbyon nuclear power plant and evicted inspectors from the United Nations International Atomic Energy Agency, or IAEA, and has reportedly resumed activity at its Yongbyon power plant. In January 2003, North Korea announced its intention to withdraw from the Nuclear Non-Proliferation Treaty, demanding that the United States sign a non-aggression pact as a condition to North Korea dismantling its nuclear program. In August 2003, representatives of Korea, the United States, North Korea, China, Japan and Russia held multilateral talks in an effort to resolve issues relating to North Korea's nuclear weapons program. While the talks concluded without resolution, participants in the August meeting indicated that further negotiations may take place in the future and, in February and June 2004, six-party talks were held in Beijing, China. In June 2004, the third round of the six-party talks resumed in Beijing, which ended with an agreement by the parties to hold further talks by the end of September 2004, which failed to take place as planned due to North Korea's refusal to participate.

In February 2005, North Korea announced that it possesses nuclear weapons and that it is suspending indefinitely its participation in the six-party talks. Since then, various efforts have been made to pressure North Korea to resume participation in the six-party talks, with little success. In April 2005, tensions increased due to rising suspicions that North Korea is preparing to engage in nuclear testing and allegations that North Korean nuclear weapons material had been sold to Libya. In May 2005, two senior U.S. officials met with North Korean diplomats in working-level contact (a term that refers to diplomatic contact below the highest levels) in an effort by the United States to bring North Korea back to the negotiation table. On June 11, 2005, South Korean President Roh Moo-hyun met with US President George W. Bush in Washington and they confirmed that the nuclear issue of North Korea should be settled in a peaceful manner. Recently, North Korean leader Mr. Kim Jong-il reportedly expressed its intention to rejoin the

international nuclear disarmament negotiations on conditions, among others, that the United States take measures to show respect to North Korea.

There can be no assurance that the level of tensions will not escalate, as has frequently happened in the past. Any further increase in tensions, which may occur, for example, if military hostilities break out, could hurt our business, financial

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condition and results of operations.

Disruptions in Taiwan's political environment could seriously harm our business and operations in Taiwan.

The government of China asserts sovereignty over mainland China and Taiwan and does not recognize the legitimacy of the government of Taiwan. The government of China has indicated that it may use military force to gain control over Taiwan if Taiwan declares independence or a foreign power interferes in Taiwan's internal affairs. On December 31, 2003, the Republic of China Referendum Law was promulgated allowing referenda on a range of issues to be proposed and voted upon. The law allows a referendum on key constitutional issues in the event that Taiwan comes under military attack from a foreign power and its sovereignty is threatened. On March 19, 2004, Taiwan's incumbent president was injured in an assassination attempt, and the next day narrowly won a majority of votes in Taiwan's presidential election. The incumbent president was sworn into office for a second term on May 20, 2004 after a vote recount resulting from a legal challenge to the election results filed by the opposition party. The High Court of Taiwan ruled in two different lawsuits against the opposition party in November and December 2004, against which the opposition party appealed. In June 2005, the Supreme Court of Taiwan ruled in one of the lawsuits against the opposition party and such judgment is final and conclusive. The other lawsuit is still pending with the Supreme Court of Taiwan. In 2003 and 2004, we derived 24.2% and 22.7% of our total revenues from our licensee in Taiwan.

Deteriorations in the relationship between Taiwan and China and other factors affecting Taiwan's political environment may materially and adversely affect our Taiwanese licensee's business and our results of operations.

The economic, political and social conditions, as well as government policies in China, could adversely affect our operations in China.

In 2003 and 2004, we derived 4.2% and 4.4% of our total revenues from our licensee in China, respectively. While the Chinese economy has experienced significant growth in the past twenty years, growth has been uneven, both geographically and among various sectors of the economy. The Chinese government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures benefit the overall Chinese economy, but may also have a negative effect on us. For example, our financial condition and results of operations may be adversely affected by government control over capital investments or changes in tax regulations that are applicable to us or our licensees.

The Chinese economy has been transitioning from a planned economy to a more market-oriented economy. Although the Chinese government has implemented measures since the late 1970s emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets and the establishment of sound corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the Chinese government. In addition, the Chinese government continues to play a significant role in regulating industry development by imposing industrial policies. The Chinese government also exercises significant control over China's economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies.

Risks Relating to Our American Depositary Shares

Mr. Jung Ryool Kim, one of our executive directors and our largest shareholder, has substantial control over us and can delay or prevent a change in corporate control.

As of June 29, 2005, Mr. Jung Ryool Kim, one of our executive directors and our largest shareholder, beneficially owned, in the aggregate, approximately 48.9% of our outstanding common shares. As a result, Mr. Kim can exert significant control over all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. This voting power can delay or prevent an acquisition of us on terms that other shareholders may desire. Mr. Kim also has the power to prevent or cause a change in control. In addition, the rights of minority shareholders and the fiduciary obligations of directors and majority shareholders in Korea may not be as extensive as those in the United States, and the ability to assert shareholder rights may be comparatively limited. Mr. Kim owns our corporate headquarters building which we lease from him.

The public shareholders of our ADSs may have more difficulty protecting their interests than they would as shareholders of a U.S. corporation.

Our corporate affairs are governed by our articles of incorporation and by the laws and regulations governing Korean corporations. The rights and responsibilities of our shareholders and members of our board of directors under

Korean law may be different from those that apply to shareholders and directors of a U.S. corporation. For example, minority shareholder

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rights afforded under Korean law often require the minority shareholder to meet minimum shareholding requirements in order to exercise certain rights. Under applicable Korean law, a shareholder must own at least (i) one percent of the total issued shares to bring a shareholders' derivative lawsuit, (ii) three percent to demand an extraordinary meeting of shareholders, demand removal of directors or inspect the books and related documents of a company, (iii) ten percent to apply to the court for dissolution if there is gross improper management or a deadlock in corporate affairs likely to result in significant and irreparable injury to the company or to apply to the court for reorganization in the case of an insolvency and (iv) 20 percent to block a share exchange approved only by a board resolution. In addition, while the facts and circumstances of each case will differ, the duty of care required of a director under Korean law may not be the same as the fiduciary duty of a director of a U.S. corporation. Although the concept of a business judgment rule exists in Korea, there is insufficient case law or precedent to provide guidance to the management and shareholders as to how it should be applied or interpreted in a particular circumstance. Holders of our ADSs may have more difficulty protecting their interests against actions of our management, members of our board of directors or controlling shareholder than they would as shareholders of a U.S. corporation.

Any dividends paid on our common shares will be in the Korean Won and fluctuations in the exchange rate between the Won and the U.S. dollar may affect the amount received by you.

If and when we declare cash dividends, the dividends will be paid to the depositary for the ADSs in Won and then converted by the depositary into U.S. dollars in connection with the deposit agreement. Fluctuations in the exchange rate between the Won and the U.S. dollar will affect, among other things, the U.S. dollar amounts you will receive from the depositary as dividends. Holders of ADSs may not receive dividends if the depositary does not believe it is reasonable or practicable to do so. In addition, the depositary may collect certain fees and expenses, at the sole discretion of the depositary, by billing the holders of ADSs for such charges or by deducting such charges from one or more cash dividends or other cash distributions from us to be distributed to the holders of ADSs.

Your ability to deposit or withdraw common shares underlying the ADSs into and from the depositary facility may be limited, which may adversely affect the value of your investment.

Under the terms of our deposit agreement, holders of our common shares may deposit such shares with the depositary's custodian in Korea and obtain ADSs, and holders of our ADSs may surrender the ADSs to the depositary and receive our common shares. However, to the extent that a deposit of common shares exceeds the difference between:

- the aggregate number of common shares we have consented to be deposited for the issuance of ADSs (including deposits in connection with offerings of ADSs and stock dividends or other distributions relating to ADSs); and

- the number of common shares on deposit with the custodian for the benefit of the depositary at the time of such proposed deposit,

such common shares will not be accepted for deposit unless (i) our consent with respect to such deposit has been obtained or (ii) such consent is no longer required under Korean laws and regulations or under the terms of the deposit agreement.

Under the terms of the deposit agreement, no consent is required if the common shares are obtained through a dividend, free distribution, rights offering or reclassification of such shares. Under the terms of the deposit agreement, we have consented to any deposit, provided that such deposit may be made only after 180 days from February 8, 2005, the date of our initial offering, to the extent that, after the deposit, the aggregate number of deposited common shares does not exceed 3,552,229 common shares (including common shares sold in the form of ADSs), or any greater number of common shares we determine from time to time (i.e., as a result of a subsequent offering, stock dividend or rights offer), unless the deposit is prohibited by applicable laws or violates our articles of incorporation; provided, however, that if the over-allotment option granted to the underwriters is exercised or in the case of any subsequent offer by us or our affiliates, the limit on the number of common shares on deposit shall not apply to such over-allotment or offer and the number of common shares issued, delivered or sold pursuant to the over-allotment or offer (including common shares in the form of ADSs) shall be eligible for deposit under the deposit agreement, except to the extent such deposit is prohibited by applicable laws or violates our articles of incorporation, or, in the case of

any subsequent offer by us or our affiliates, we determine with the depository to limit the number of common shares so offered that would be eligible for deposit under the deposit agreement in order to maintain liquidity of the shares in Korea as may be requested by the relevant Korean authorities. We might not consent to the deposit of any additional common shares. As a result, if a holder surrenders ADSs and withdraws common shares, it may not be able to deposit the common shares again to obtain ADSs.

You may not be able to exercise preemptive rights or participate in rights offerings and may experience dilution of your holdings.

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The Korean Commercial Code and our articles of incorporation require us to offer shareholders the right to subscribe for new common shares in proportion to their existing ownership percentages whenever new common shares are issued, except under certain circumstances as provided in our articles of incorporation.

Such exceptions include offering of new shares:

through a general public offering,

to the members of the employee stock ownership association,

upon exercise of a stock option,

in the form of depositary receipts,

to induce foreign direct investment necessary for business in accordance with the Foreign Investment Promotion Act of Korea,

for the purpose of raising funds on an emergency basis,

as necessary for the inducement of technology, to certain companies under an alliance arrangement with us, or

by a public offering or subscribed for by the underwriters for the purpose of listing on the Korean public stock markets.

Accordingly, if we issue new shares to non-shareholders based on such exception, a holder of our ADSs will be diluted. If none of the above exemptions is available under Korean law, we may be required to grant subscription rights when issuing additional common shares. However, under U.S. law, we would not be able to make those rights available in the United States unless we register the securities to which the rights relate or an exemption from the registration requirements of the U.S. Securities Act is available. Under the deposit agreement governing the ADSs, if we offer rights to subscribe for additional common shares, the depositary under the deposit agreement, after consultation with us, may make such rights available to you or dispose of such rights on behalf of you and make the net proceeds available to you or, if the depositary is unable to take such actions, it may allow the rights to lapse with no consideration to be received by you. The depositary is generally not required to make available any rights under any circumstances. We are under no obligation to file a registration statement under the Securities Act to enable you to exercise preemptive rights in respect of the common shares underlying the ADSs, and we cannot assure you that any registration statement would be filed or that an exemption from the registration requirement under the Securities Act would be available. Accordingly, you may not be entitled to exercise preemptive rights and may thereby suffer dilution of your interests in us.

You will not be treated as our shareholder and you will not have shareholder rights such as the voting rights of a holder of common shares.

As an ADS holder, we will not treat you as one of our shareholders and you will not have the rights of a shareholder. Korean law governs shareholder rights. The depositary will be the shareholder of the common shares underlying your ADSs. As a holder of ADSs, you will have ADS holder rights. A deposit agreement among us, the depositary and you, as an ADS holder, sets out ADS holder rights as well as the rights and obligations of the depositary. New York law governs the deposit agreement and the ADSs. Upon receipt of the necessary voting materials, you may instruct the depositary to vote the number of shares your ADSs represent. The depositary will notify you of shareholders' meetings and arrange to deliver our voting materials to you only when we deliver them to the depositary with sufficient time under the terms of the deposit agreement. If there is a delay, we cannot ensure that you will receive voting materials or otherwise learn of an upcoming shareholders' meeting in time to ensure that you may instruct the depositary to vote your shares. In addition, the depositary and its agents are not responsible for failing to carry out voting instructions or for the manner of carrying out voting instructions.

You would not be able to exercise dissent and appraisal rights unless you have withdrawn the underlying common shares from the depositary facility and become our direct shareholders.

In some limited circumstances, including the transfer of the whole or any significant part of our business, our acquisition of a part of the business of any other company having a material effect on our business, our merger or consolidation with

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another company, dissenting shareholders have the right to require us to purchase their shares under Korean law. However, if you hold our ADSs, you will not be able to exercise such dissent and appraisal rights unless you have withdrawn the underlying common shares from the depository facility and become our direct shareholder prior to the record date for the shareholders' meeting at which the relevant transaction is to be approved.

We may amend the deposit agreement and the ADRs without your consent for any reason and, if you disagree, your option will be limited to selling the ADSs or withdrawing the underlying securities.

We may agree with the depository to amend the deposit agreement and the American depository receipts, or ADRs, without your consent for any reason. If an amendment adds or increases fees or charges, except for taxes and other governmental charges or expenses of the depository, for registration fees, facsimile costs, delivery charges or similar items, or prejudices a substantial right of ADS holders, it will not become effective for outstanding ADRs until 30 days after the depository notifies ADS holders of the amendment. At the time an amendment becomes effective, you are considered, by continuing to hold your ADSs, to agree to the amendment and to be bound by the ADRs and the deposit agreement as amended. If you do not agree with an amendment to the deposit agreement or the ADRs, your option is limited to selling the ADSs or withdrawing the underlying securities. No assurance can be given that the sale of ADSs would be made at a price satisfactory to you in such circumstances. In addition, as of the date hereof, the common shares underlying the ADSs are not listed on any stock exchange in Korea. Your ability to sell the underlying common shares following withdrawal and the liquidity of the common shares may be limited.

You may be subject to Korean withholding tax.

Under Korean tax law, if you are a U.S. investor, you may be subject to Korean withholding taxes on capital gains and dividends in respect of the ADSs unless an exemption or a reduction under the income tax treaty between the United States and Korea is available. Under the United States-Korea tax treaty, capital gains realized by holders that are residents of the United States eligible for treaty benefits will not be subject to Korean taxation upon the disposition of the ADSs. However, under the United States-Korea income tax treaty, the following holders are not eligible for such tax treaty benefits: (i) in case the holder is a United States corporation, if by reason of any special measures, the tax imposed on such holder by the United States with respect to such capital gains is substantially less than the tax generally imposed by the United States on corporate profits, and 25% or more of the holder's capital is held of record or is otherwise determined, after consultation between competent authorities of the United States and Korea, to be owned directly or indirectly by one or more persons who are not individual residents of the United States and (ii) in case the holder is an individual, if such holder maintains a fixed base in Korea for a period or periods aggregating 183 days or more during the taxable year and the holder's ADSs or common shares giving rise to capital gains are effectively connected with such fixed base or such holder is present in Korea for a period or periods of 183 days or more during the taxable year.

You may have difficulty bringing an original action or enforcing any judgment obtained outside Korea against us, our directors and officers or other offering participants, such as underwriters or experts, who are not U.S. persons.

We are organized under the law of Korea, and all of our directors and officers reside in Korea. All or a significant portion of our assets and the assets of such persons are located outside of the United States. As a result, it may not be possible for you to effect service of process within the United States upon these persons or to enforce against them or us court judgments obtained in the United States that are predicated upon the civil liability provisions of the federal securities laws of the United States or of the securities laws of any state of the United States. We have, however, irrevocably appointed an agent in New York to receive service of process in any proceedings in the State of New York relating to our ADSs. Notwithstanding the foregoing, there is doubt as to the enforceability in Korea, either in original actions or in actions for enforcement of judgments of United States courts, of civil liabilities predicated on the federal securities laws of the United States or the securities laws of any state of the United States.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion of the Company's financial condition and results of operations has been revised to reflect the restatement and certain events occurring subsequent to the filing of the Original Filing, as well as to incorporate certain conforming changes. The following discussion should be read in conjunction with the Restated Financial Statements and the Notes thereto appearing elsewhere in this Amendment No. 1.

Overview

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As described in Note 2 (Restatement) of the Notes to the Restated Financial Statements, the restatements principally relate to the following:

The diversion of revenues attributable to the Company by the former Chairman during the years ended December 31, 2002, 2003 and 2004. The Restated Financial Statements include such revenue in the period when it would have been recognized by the Company, had the diversion not occurred. These amounts are recorded as Misappropriated funds receivable in the restated consolidated balance sheets as of December 31, 2003 and 2004. In addition, the Restated Financial Statements include the recognition of expenses for royalty payments due to several third parties relating to the Company's Ragnarok game that were not recognized as expense in the relevant periods as a result of the diversion of revenues by the former Chairman. The Restated Financial Statements include such expenses as cost of revenue or interest expense, as applicable, in the period when the related revenue is recorded in the restated consolidated statement of operations for the years ended December 31, 2002, 2003 and 2004 and as an amount payable to the relevant parties in the restated consolidated balance sheets as of December 31, 2003 and 2004.

The misappropriation of certain assets, previously recorded as fixed assets in the Company's consolidated financial statements. The Restated Financial Statements include an adjustment from the Original Financial Statements related to the purchase by the Company of certain assets that were recorded as fixed assets in the Original Financial Statements. The Company determined based on the Investigation Reports, that these assets could not be identified and management and the audit committee concluded that such assets should have been recorded as expense in the Company's financial statements at their purchase date, as it is unlikely that the Company received any benefit from the purchase of the assets. Additionally, the Original Financial Statements included depreciation expense related to these assets in the years ended December 31, 2003 and 2004. Depreciation expenses have not been recorded in the Restated Financial Statements for the years ended December 31, 2003 and 2004 as the costs of such assets are fully expensed at their acquisition date in these statements.

Improper and intentional early recognition of certain revenue in connection with the Company's mobile games revenue and character merchandising, animation and other revenue relating to products in the year ended December 31, 2004. U.S. GAAP requires that revenue should not be recognized until delivery of the product or completion of service. The restated consolidated statement of operations for the year ended December 31, 2004 include adjustments to reduce the amount of revenue recognized in that year as the product contracted for had not been delivered by year end.

The impact of the above adjustments on foreign currency gains(losses), net is recorded in the Restated Financial Statements due to the timing difference in the recognition of revenue and the receipt of the revenues by the Company.

The impact of the above adjustments on the provision for income taxes has been reflected in the year in which the items are recorded in the Restated Financial Statements. Which consists of changes in the deferred tax assets and liabilities resulting from the misappropriation by the former Chairman, and increases in penalties and interest payable for inaccurate reporting of taxes in the years when the diversion took place.

The Company had incorrectly recorded certain foreign tax credits in prior periods. Additionally, the Company had previously amended credits recorded in one period by adjusting the balance of the credits at the end of the subsequent period. The Restated Financial Statements now reflect the correct foreign tax credits in the year in which they should have been recorded.

The Restated Financial Statements do not reflect all of the issues noted in the Investigation Reports, as certain findings could not ultimately be corroborated based on the available evidence. Subsequent to the discovery of the embezzlement, the former Chairman paid \$7.8 billion to the Company in October 2005. In addition, the former

Chairman has agreed to pay an additional amount to the Company, in part to reimburse the Company for certain of the costs and expenses incurred by the Company in connection with the Investigation.

Please refer to Note 2 of the Notes to the Restated Financial Statements for a discussion of the adjustments to specific line items of the Restated Financial Statements. This Amendment No. 1 does not modify or update disclosures presented in the Original Filing, except as required to reflect the effects of the restatements. Except for disclosures affected by the restatements, this Amendment No. 1 speaks as of the filing date of the Original Filing and does not modify or update disclosures in the Original Filing, including the nature and character of such disclosures, to reflect events occurring or items discovered after the filing date of the Original Filing. Accordingly, this Amendment No. 1 should be read in conjunction with the Company's filings and submissions made with the SEC subsequent to the filing date of the Original Filing, including any amendments to those filings and submissions.

Restatement of the Original Financial Statements

The following sets forth certain items of the Company's consolidated statement of operations as previously reported in the Original Financial Statements and as restated for each of the periods indicated and a description of such restatements.

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	For the year ended December 31,						
	2002		2003		2004		2004 ⁽¹⁾
	(As previously reported)	(As restated)	(As previously reported)	(As restated)	(As previously reported)	(As restated)	(As restated)
(In millions of Won and thousands of Dollars)							
Revenues							
Online games-royalties and license fees	₩ 2,079	₩ 2,330	₩22,804	₩29,727	₩44,236	₩45,101	US\$46,629
Mobile games			43	43	480	376	387
Character merchandising, animation and other	427	427	1,024	1,185	3,471	2,696	2,775
Total net revenues	9,816	10,067	42,431	49,515	64,440	64,426	66,323
Cost of revenues	1,735	1,738	6,866	6,958	10,309	10,116	10,414
Operating Expenses	5,771	5,685	12,712	12,957	15,749	15,689	16,151
Other income (expense)-interest expense	(2,480)	(2,583)	(5,947)	(6,465)	(4,309)	(4,732)	(4,871)
Other income (expense)-foreign currency translation	58	76	178	135	(716)	(625)	(644)
Income tax expenses	467	542	2,535	4,250	4,402	5,406	5,565
Equity in loss of related joint venture					(248)	(296)	(305)
Net income (loss)	₩ (496)	₩ (322)	₩14,669	₩19,140	₩29,201	₩28,057	US\$28,883

Note:

(1) For convenience, the Won amounts are expressed in U.S. dollars at the rate of ₩971.4 to US\$1.00, the noon buying rate in effect on March 31, 2006 as quoted by the Federal Reserve Bank of New York.

Revenues

As a result of the activities which necessitated the restatements to the Company's Original Financial Statements, our total net revenues increased by ₩251 million and ₩7,084 and decreased by ₩14 million in 2002, 2003 and 2004, respectively, from the previously reported amounts for such periods in the Original Financial Statements of ₩9,816 million, ₩42,431 million and ₩64,440 million in 2002, 2003 and 2004, respectively, to ₩10,067 million, ₩49,515 million and ₩64,426 million in 2002, 2003 and 2004, respectively, due to the following adjustments:

online games royalties and license fees increased by ~~W~~251 million, ~~W~~6,923 million and ~~W~~865 million in 2002, 2003 and 2004, respectively, from the previously reported amounts for such periods in the Original Financial Statements of ~~W~~2,079 million, ~~W~~22,804 million and ~~W~~44,236 million in 2002, 2003 and 2004, respectively, to ~~W~~2,330 million, ~~W~~29,727 million and ~~W~~45,101 million in 2002, 2003 and 2004, respectively, to account for the license fees and monthly running royalties which were omitted from the consolidated statement of operations in such years resulting from the diversion of revenues due to the Company by the former Chairman;

mobile games revenue and character merchandising, animation and other revenue decreased by ~~W~~104 million and ~~W~~775 million in 2004, respectively, from the previously reported amount for 2004 in the Original Financial Statements of ~~W~~480 million and ~~W~~3,471 million, respectively, to ~~W~~376 million and ~~W~~2,696 million, respectively, to account for the improper and intentional early recognition of certain revenue in connection with the Company's mobile games revenue and character merchandising and other revenue relating to products in the year ended December 31, 2004. U.S. GAAP requires that revenue should not be recognized until delivery of the product or completion of service. The restated consolidated statement of operations for the year ended December 31, 2004 includes an adjustment to reduce the amount of revenue recognized in that year as certain of the products contracted for had not been delivered by year-end.

character merchandising, animation and other revenue increased by ~~W~~161 million in 2003 from the previously reported amount in the Original Financial Statements of ~~W~~1,024 million to ~~W~~1,185 million due to the diversion of running royalties related to character merchandising by the former Chairman.

Cost of Revenues

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As a result of the activities which necessitated the restatements to the Company's Original Financial Statements, our cost of revenues increased by ₩3 million and ₩92 million and decreased by ₩193 million in 2002, 2003 and 2004, respectively, from the previously reported amounts for such periods in the Original Financial Statements of ₩1,735 million, ₩6,866 million and ₩10,309 million in 2002, 2003 and 2004, respectively, to ₩1,738 million, ₩6,958 million and ₩10,116 million in 2002, 2003 and 2004, respectively. The increases in cost of revenues for each of the years were attributable to increased expenses that should have been recorded at the same time as the omitted revenues as these amounts are royalty payments due to a third party relating to the Company's Ragnarok Online game that were not recognized as an expense in the relevant periods as a result of the diversion of revenues by the former Chairman. The decrease in the cost of revenues was due to:

decreases in depreciation expense of ₩4.0 million in 2003 and ₩47.0 million in 2004 related to certain misappropriated assets, as the Company fully expensed the purchase costs of these assets at the time of their acquisition in the Restated Financial Statements; and

decreases in license fees payable to third parties of ₩159 million resulting from reduction in revenue in the year ended December 31, 2004 attributable to the improper and intentional early recognition of certain revenue in connection with the Company's character merchandising, animation and other revenue relating to products sold in 2004.

Operating Expenses

As a result of the activities which necessitated the restatements to the Company's Original Financial Statements, our operating expenses decreased by ₩86 million, increased by ₩245 million and decreased by ₩60 million in 2002, 2003 and 2004, respectively, from the previously reported amounts for such periods in the Original Financial Statements of ₩5,771 million, ₩12,712 million and ₩15,749 million in 2002, 2003 and 2004, respectively, to ₩5,685 million, ₩12,957 million and ₩15,689 million in 2002, 2003 and 2004, respectively.

The restatements of the operating expenses reflect the following principal adjustments:

Tax and dues increased in 2002 and 2003 due to value added tax penalties;

Advertising expenses related to advertising decreased in 2002 and 2003 due to increased advertising reimbursement received from a third party as a result of increased royalty payments paid to such third party in such years arising from increased revenues recognized in such years due to the diversion of royalty payments by the former Chairman; and

Expenses related to certain misappropriated assets and depreciation expenses recognition of expense for certain assets purchased and paid for by the Company and previously recorded as fixed assets in the Original Financial Statements and decreases in depreciation expenses related to the misappropriated assets as such assets were fully expensed at their acquisition date in the Restated Financial Statements.

Other Income (Expense)

Other expenses increased by ₩85 million, ₩561 million and ₩331 million in 2002, 2003 and 2004, respectively from ₩2,339 million, ₩5,649 million and ₩4,548 million, in 2002, 2003 and 2004, respectively to ₩2,424 million, ₩6,210 million and ₩4,879 million in 2002, 2003 and 2004, respectively, as a result of the activities which necessitated the restatements to the Company's Original Financial Statements. The increases primarily reflect the following adjustments:

Interest expenses interest expense increased in 2002, 2003 and 2003 due to increased payment attributable to interest in connection with payments made to third parties resulting from increased revenues due to the former Chairman's diversion of certain royalty payments; and

Foreign currency gains (losses), net foreign currency gains (losses), net increased in 2002 and 2004 and decreased in 2003 due to the timing difference in the recognition of revenue and the receipt of the revenues by the Company.

Income Tax Expenses

Income tax expenses increased by ~~₩~~75 million, ~~₩~~1,715 million and ~~₩~~1,004 million in 2002, 2003 and 2004, respectively from ~~₩~~467 million, ~~₩~~2,535 million and ~~₩~~4,402 million, in 2002, 2003 and 2004, respectively to ~~₩~~542 million,

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₩4,250 million and ₩5,406 million in 2002, 2003 and 2004, respectively due to changes in deferred tax assets and liabilities and increases in penalties and interest payable by the Company, all as a result of the foregoing changes in the Company's revenues and expenses.

The following sets forth certain items of the Company's consolidated balance sheets as previously reported in the Original Financial Statements and as restated for each of the periods indicated and a description of such restatements.

	As of the year ended December 31,							2004 ⁽¹⁾
	2002		2003		2004			
	(As previously reported)	(As restated- unaudited) ⁽²⁾	(As previously reported)	(As restated)	(As previously reported)	(As restated)	(As restated)	
(In millions of Won and thousands of Dollars)								
Assets:								
Accounts receivable, net	₩ 5,852	₩ 6,008	₩ 6,988	₩ 7,011	₩ 7,321	₩ 7,377		US\$ 7,594
Misappropriated funds receivable-current							7,482	7,702
Deferred expense	558	793	651	963	2,530	2,588		2,664
Current deferred income tax asset			504	536	2,684	1,692		1,742
Other current assets	455	555	2,156	2,309	2,258	2,424		2,495
Total current assets	7,425	7,916	17,304	17,824	40,098	46,868		48,247
Property and equipment, net	2,254	2,254	5,694	5,417	14,951	14,760		15,195
Misappropriated funds receivable-non current		1,235		7,441				
Other non current assets	735	1,117	1,854	1,829	2,893	2,824		2,907
Total assets	₩ 11,509	₩ 13,617	₩ 28,765	₩ 36,424	₩ 62,134	₩ 68,644		US\$ 70,665
Liabilities:								
Accounts Payable	₩ 1,981	₩ 1,995	₩ 2,432	₩ 2,518	₩ 3,576	₩ 3,742		US\$ 3,852
Deferred income	1,056	1,497	2,671	3,409	4,392	5,639		5,805
Current portion of long-term debt	3,382	3,479	2,633	2,630	1,278	1,150		1,184
Accrued interest	1,037	1,059	678	749	271	318		327
Income tax payable	211	211	476	1,109	478	1,172		1,207
Other current liabilities	10	10	161	160	324	200		206
Total current liabilities	7,677	8,251	9,051	10,575	10,319	12,221		12,581
Long-term deferred income	486	1,253	380	849	1,918	1,958		2,016
Long-term debt	3,445	3,333	1,164	1,046				
Long-term accounts payable		706		1,138		1,063		1,094
			8	10	7	7		7

Other non current liabilities								
Total liabilities	11,772	13,707	10,945	13,960	15,204	18,209	18,745	
Retained earnings	(1,753)	(1,580)	12,916	17,560	42,117	45,617	46,960	
Accumulated other comprehensive loss	(210)	(210)	(2)	(2)	(141)	(137)	(141)	
Total shareholder s equity	(263)	(90)	17,820	22,464	46,930	50,435	51,920	
Total liabilities and shareholder s equity	₩ 11,509	₩ 13,617	₩ 28,765	₩ 36,424	₩ 62,134	₩ 68,644	US\$ 70,665	

Notes:

- (1) For convenience, the Won amounts are expressed in U.S. dollars at the rate of ₩971.4 to US\$1.00, the noon buying rate in effect on March 31, 2006 as quoted by the Federal Reserve Bank of New York.
- (2) The balance sheet data as of the year ended December 31, 2002 are derived from our unaudited financial statements and related notes thereto, which are not included in this Amendment No. 1.

Total assets

As a result of activities which necessitated the restatements to the Company s Original Financial Statements, our total assets increased by ₩2,108 million, ₩7,659 million and ₩6,510 million in 2002, 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements of ₩11,509 million, ₩28,765 million and ₩62,134 million for 2002, 2003 and 2004, respectively, to ₩13,617 million, ₩36,424 million and ₩68,644 million in 2002, 2003 and 2004, respectively, principally due to the following adjustment:

Misappropriated funds receivable-current increased by ₩7,482 million in 2004 from the previously reported amount in the Original Financial Statements of nil to ₩7,482 million in 2004, and due from misappropriated funds receivable-non current increased by ₩1,235

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million and ₩7,441 million in 2002 and 2003, respectively, from the previously reported amounts in the Original Financial Statements of nil in 2002 and 2003, respectively, to ₩1,235 million and ₩7,441 million in 2002 and 2003, respectively, in each of the years to account for the omitted revenue resulting from the diversion of revenues attributable to the Company by the former Chairman.

In addition, there were certain adjustments to deferred expense, accounts receivable, net, current deferred income tax asset and other current assets in each of the years.

Total liabilities

As a result of activities which necessitated the restatements to the Company's Original Financial Statements, total liabilities increased by ₩1,935 million, ₩3,015 million and ₩3,005 million in 2002, 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements of ₩11,772 million, ₩10,945 million and ₩15,204 million in 2002, 2003 and 2004, respectively, to ₩13,707 million, ₩13,960 million and ₩18,209 million in 2002, 2003 and 2004, respectively, principally due to the following adjustments:

Deferred income increased by ₩441 million, ₩738 million and ₩1,247 million in 2002, 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements of ₩1,056 million, ₩2,671 million and ₩4,392 million in 2002, 2003 and 2004, respectively, to ₩1,497 million, ₩3,409 million and ₩5,639 million in 2002, 2003 and 2004, respectively, and long-term deferred income increased by ₩767 million, ₩469 million and ₩40 million in 2002, 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements of ₩486 million, ₩380 million and ₩1,918 million in 2002, 2003 and 2004, respectively, to ₩1,253 million, ₩849 million and ₩1,958 million in 2002, 2003 and 2004, respectively, in each case due to increase in additional initial license fees which should be recognized over the relevant contract terms, resulting from the former Chairman's diversion of royalty payments due to the Company and the decrease in revenues attributable to the improper and early recognition of revenues relating to the Company's mobile games and character merchandising, animation and other revenues in 2004;

Income tax payable increased by ₩633 million and ₩694 million in 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements of ₩476 million and ₩478 million in 2003 and 2004, respectively, to ₩1,109 million and ₩1,172 million in 2003 and 2004, respectively, due to the tax penalty; and

Long-term accounts payable increased by ₩706 million, ₩1,138 million and ₩1,063 million in 2002, 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements of nil in 2002, 2003 and 2004, respectively, due to the recording of additional payments due to certain third parties as a result of the increase in revenues in such year.

5.A. Operating Results (as restated)

We are based in Korea and are a leading developer and distributor of online games in Japan, Taiwan and Thailand based on the number of peak concurrent users. From our inception in April 2000 until commercialization of our first online game, Ragnarok Online, in August 2002, our operating activities were limited primarily to developing Ragnarok Online and rolling out a free test, or beta-test, version of Ragnarok Online in November 2001. During this period, we generated revenues of ₩405 million in 2000 by purchasing and reselling computer components and ₩167 million in 2001 from the sale of Arcturus, a PC-based game.

Ragnarok Online is currently commercially offered in Korea, the United States and Canada by us and in 17 other overseas markets by our overseas licensees, and has accounted for 95.2% of our revenues in 2004. Revenues generated from Ragnarok Online are determined largely by the following factors: pricing and pricing structure, the number of Ragnarok Online users and the average number of hours users spend playing Ragnarok Online. In order to play Ragnarok Online, users either pay a flat monthly fee or purchase a fixed number of game hours. The pricing structure of Ragnarok Online in a given country is determined primarily based on the cost of publishing and operating Ragnarok Online, the playing and payment patterns of users, the pricing of competing games and the income per capita of consumers in that country. The pricing of Ragnarok Online is determined by us in Korea, the United States and Canada, and, in other countries, by our overseas licensees after consultation with us and has remained generally stable since its commercial launch in each of the countries in which it is distributed. Due to competitive pressure and

in line with market practice, we and our licensees have not raised prices for Ragnarok Online following its commercial launch in a country. The aggregate number of Ragnarok Online users has increased as we have entered into new markets primarily through our licensees and as the number of Ragnarok Online users in existing markets has increased. The number of Ragnarok Online users and the amount of Ragnarok Online usage in a given

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country depend in part on the perceived quality of Ragnarok Online and the level of local competition. While it is difficult to accurately determine what accounts for the superior quality of an online game, we believe that Ragnarok Online's storyline, graphics and community-oriented themes, together with our ability to timely maintain, update and enhance the content and technical aspects of the game, have been largely responsible for the game's commercial success.

In Korea, Sunny YNK Inc. has the exclusive right to distribute Ragnarok Online until July 2005, although we have handled marketing, operation and billing of Ragnarok Online since its commercial launch. In overseas markets other than the United States and Canada, our licensees handle such functions under a licensing agreement with us, under which we generally receive license fees and royalty payments. The term of the licensing agreement is typically two years, and renewing licensees typically pay a lump-sum renewal fee in addition to ongoing royalty payments. The major overseas markets in which we offer Ragnarok Online through our licensees are Japan, Taiwan, Thailand and China in terms of revenue contribution, and our licensees are GungHo Online Entertainment Inc. in Japan, Soft-World International in Taiwan, Value Central in China and Asia Soft International in Thailand.

Since Ragnarok Online's initial commercial launch in August 2002, we have experienced significant growth in revenues and net income. Our revenues increased by 30.1% to ₩64,426 million (US\$66,323 thousand) in 2004 from ₩49,515 million in 2003 and by 391.9% to ₩49,515 million in 2003 from ₩10,067 million in 2002. Our net income increased by 46.6% to ₩28,057 million (US\$28,883 thousand) in 2004 from ₩19,140 million in 2003 and we recorded net income of ₩19,140 million in 2003 as compared to net loss of ₩322 million in 2002. Our gross profit margin also increased from 82.7% in 2002 to 85.9% in 2003 and to 84.3% in 2004 and our operating margin increased from 26.3% in 2002 to 59.8% in 2003 to 59.9% in 2004. We attribute our revenue growth largely to our early entry into additional markets since Ragnarok Online's commercial launch and the continuing popularity of Ragnarok Online among users in the existing markets. We attribute our margin improvement to the scalability of the online game business. Once a game is launched and the initial development and marketing costs have been expensed, relatively low marginal costs are incurred to expand into additional markets through licensing arrangements. Our revenue growth may be adversely affected in the future by the popularity of online games newly introduced by our competitors. Our future success depends largely on our ability to develop or publish commercially successful new online games.

In January 2005, we commercially launched R.O.S.E. Online, our second online game, in Korea. We currently plan to commercially launch R.O.S.E. Online in one or more of our other key markets. Despite our commercial launch of R.O.S.E. Online, our revenues and net income declined in the first quarter of 2005 as compared to those of the first quarter of 2004 and the fourth quarter of 2004. The decrease in revenues was primarily due to the continuing decline in subscription revenues from Ragnarok Online in Korea. Royalties and license fees from overseas markets remained relatively constant in the first quarter of 2005 as compared to the fourth quarter of 2004. Our operating expenses for the first quarter of 2005 increased as compared to those of the first quarter of 2004 and the fourth quarter of 2004 due primarily to the stock options expenses that we incurred and the increase in labor-related expenses. Our future results of operations will also be affected by our ability to renew our status as a designated small- and medium-sized venture company and qualify for preferential treatment of the 50% reduction in corporate income tax rate through 2007 as described in Income tax expenses. Our income tax rate in 2004 was 14.85%. In September 2005, the company was designated as a venture company and is entitled to 50% reduction in corporate income tax in 2005 and 2006, which was not reflected in deferred income tax in 2004.

Revenue recognition

We derive, and expect to continue to generate, most of our revenues from online game subscription fees paid by users in Korea, the United States and Canada, and royalties and license fees paid by our licensees in the overseas markets. Our revenues can be classified into the following four categories:

online games subscription revenue,

online games royalties and license fees,

mobile games, and

character merchandising, animation and other revenue.

Online games subscription revenue

Prepaid online game subscription fees are deferred and recognized as revenue on a monthly basis in proportion to the number of days lapsed or actual hours used of the subscription purchased.

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Online games royalties and license fees

We license the right to market and distribute our games in exchange for an initial license fee. In addition, we receive royalties based on a percentage of the licensee's sales and, currently in China, guaranteed minimum royalty payments. We generally are advised by each of our licensees as to the amount of royalties earned by us from such licensee within 15 to 25 days following the end of each month.

Initial license fees. The initial license fees are deferred and recognized ratably as revenue over the license period, which typically does not exceed two years. For a table setting forth details of each license agreement, see Item 4.B.

Business Overview Our markets Overseas markets . When the license agreements are renewed upon the expiration of their terms, we generally receive renewal license fees.

Guaranteed minimum royalty payments. In China, in addition to the initial license fee, we are entitled to receive a guaranteed minimum royalty payment for licensing the right to market and distribute Ragnarok Online. The minimum guaranteed royalty payment is US\$400,000 to be paid on a semi-annual basis, in May and in November of each year during the term of the license agreement. This guaranteed minimum royalty payment is deferred and recognized as the royalties are earned. In addition, we receive a royalty payment based on a specified percentage of the licensee's sales. Royalties that exceed the guaranteed minimum are recognized on a monthly basis as they are earned by the licensee.

Monthly royalty revenues. We also receive royalty revenues from our licensees based on an agreed percentage of the licensee's revenues from Ragnarok Online. Royalty revenues are recognized on a monthly basis after the licensee confirms its revenues based on the licensee's sales from Ragnarok Online during the month.

Mobile games revenue

Mobile games are played using mobile phones and other mobile devices. Mobile game revenues are derived from a percentage of the per-download fees that users pay to mobile telecommunication operators in Korea after deducting their service charges.

Character merchandising, animation and other revenue

We license the right to commercialize our Ragnarok characters into a variety of merchandise in exchange for an initial prepaid license fee and guaranteed minimum royalty payments. The guaranteed minimum royalty payments are deferred and recognized as the royalties are earned. In addition, we receive a royalty payment based on a specified percentage of the licensee's sales. Royalties that exceed the guaranteed minimum are recognized on a monthly basis as they are earned by the licensee.

Cost of revenues

Our cost of revenues consists principally of the following:

operational expenses, server depreciation expenses, server maintenance costs and related personnel costs and amortization of development-related costs as described in Critical accounting policies Capitalized software development costs ; and

royalty payments to Mr. Myoung-Jin Lee, on whose cartoon series Ragnarok Online is based, pursuant to our license from Mr. Lee as described below.

License from Myoung-Jin Lee

In developing Ragnarok Online, we obtained an exclusive license from Mr. Myoung-Jin Lee to use the storyline and characters from his cartoon titled Ragnarok for the production of online games, animation and character merchandising. In return, we paid Mr. Lee an initial license fee of ₩40 million and are required to pay royalties based on 1.0% or 1.5% of adjusted revenues (net of value-added taxes and certain other expenses) or 2.5%, 5% or 10% of net income generated from the use of the Ragnarok brand, depending on the type of revenues received from the operation or licensing of Ragnarok Online.

The cost of revenues from the payments to Mr. Lee was ₩641 million for 2003 and ₩787 million for 2004. This

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agreement expires in January 2033.

Selling, general and administrative expenses

Selling, general and administrative expenses consist of sales commissions paid to independent promotional agents that distribute our online games to our Internet café subscribers in Korea, commissions paid to payment settlement providers, administrative expenses and related personnel expenses of executive and administrative staff, and marketing and promotional expenses and related personnel expenses.

Research and development expenses

Research and development expenses consist primarily of payroll and other overhead expenses which are all expensed as incurred until technological feasibility of a game is reached. Once technological feasibility of a game is reached, these costs are capitalized and, once commercial operation commences, amortized as cost of revenues. See

Critical accounting policies Capitalized software development costs .

Interest expense

In February and April 2002, we entered into agreements with Sunny YNK, an online game publisher in Korea listed on the KOSDAQ Market Division of the Korea Exchange, or KOSDAQ, pursuant to which we granted it the exclusive right to distribute Ragnarok Online for a contractual period of three years from the date Ragnarok Online was first commercialized. In consideration, we received a lump sum payment in the amount of ₩7,000 million at the inception of these agreements, which we recorded as debt on our balance sheet. Under the sales agency agreement that we entered into with Sunny YNK in April 2002 granting to it the exclusive distribution right, Sunny YNK owns the right to distribute Ragnarok Online in Korea. However, in practice, we perform all of the relevant marketing, advertising and selling activities, and distribute Ragnarok Online from our websites and host it on our servers.

As there is no interest rate stated in the agreement with Sunny YNK, the interest is imputed based on the difference between the principal amount of the loan and the total payments expected to be made pursuant to the agreement. Accordingly, the repayment of principal balance to Sunny YNK is variable each year in accordance with the amount of annual revenues generated from distribution of Ragnarok Online and deduction of annual interest expense allocated using the interest rate method. Pursuant to the terms of these agreements, we are obligated to make payments to Sunny YNK based on a percentage of adjusted revenues (net of value-added taxes and certain other expenses) related to Ragnarok Online as follows:

until the accumulated payments amount to ₩7,000 million, 50% of our domestic and overseas adjusted revenues from Ragnarok Online, which amount was reached in March 2003; and

once the accumulated payments exceed ₩7,000 million, 20% of our domestic adjusted revenues from Ragnarok Online and 10% of our overseas adjusted revenues from Ragnarok Online.

We incurred interest expense of ₩6,256 million in 2003 and ₩4,731 million (US\$4,870 thousand) in 2004 as a result of our arrangement with Sunny YNK. As of December 31, 2004, the outstanding balance of our debt incurred from Sunny YNK was ₩1,150 million (US\$1,184 thousand). Our agreement with Sunny YNK expires in July 2005, at which time we will no longer be obligated to make payments to Sunny YNK. In accordance with this agreement, in 2003 and 2004, we made payments of ₩7,923 million and ₩6,670 million, respectively to Sunny YNK. Additionally the Company accrued ₩403 million and ₩367 million due to Sunny YNK in 2003 and 2004, respectively. Of these payments, ₩2,843 million and ₩2,391 million were allocated to principal, and ₩5,483 million and ₩4,646 million were allocated to interest, respectively.

Pursuant to the terms of the agreement with Sunny YNK, once the cumulative royalty payments to Sunny YNK reached ₩7 billion, it is required to use 15% of future royalty payments, paid by us, to fund additional marketing of the RAGNAROK game. In March 2003, cumulative royalty payments to Sunny YNK reached ₩7 billion. After January 1, 2004, these marketing activities were performed by us and therefore, Sunny YNK reimbursed us for these costs, which was credited to advertising expenses within selling, general and administrative expenses in the accompanying statement of operations.

Foreign currency effects

In 2004, 79% of our revenues were denominated in foreign currencies, primarily in the U.S. dollar and the Japanese Yen. In most of the countries in which our games are distributed, other than the United States, Japan and

European countries, the revenues generated by our licensees are denominated in local currencies, which include the NT dollar, the Baht and the

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Renminbi, and converted into the U.S. dollar for remittance of monthly royalty payments to us. Depreciation of these local currencies against the U.S. dollar will result in reduced monthly royalty payments in U.S. dollar terms, thereby having a negative impact on our revenues.

While we receive our monthly royalty revenues from our overseas licensees in foreign currencies, primarily in the U.S. dollar, the Japanese Yen and the Euro, substantially all of our costs are denominated in the Korean Won. Our financial statements are also prepared and presented in the Korean Won. We receive monthly royalty payments from our overseas licensees based on a percentage of revenues confirmed and recorded at the end of each month applying the foreign exchange rate applicable on such date. We generally receive these royalty payments 20 to 30 days after such record date (except in Europe, where such payment could be received up to 45 days after the record date). Appreciation or depreciation of the Korean Won against these foreign currencies during this period will result in foreign currency losses or gains and affect our net income.

In 2005, we began entering into derivatives arrangements to hedge against the risk of foreign currency fluctuations. As of June 29, 2005, we had foreign currency forward contracts outstanding in the aggregate notional amount of US\$70 million. See Item 11 Quantitative and Qualitative Disclosures about Market Risk .

Income tax expenses

Under Korean law and regulations, certain designated small- and medium-sized venture companies may be entitled to enjoy preferential tax treatment from the Korean government in the form of a 50% reduction in corporate income tax rate during the year in which they first generated taxable income and the following five years if such venture companies satisfy a number of financial and non-financial criteria (including the maintenance of their status as designated venture companies). We have had the benefit of the 50% reduction in corporate income tax rate in 2003 and 2004. Our current applicable corporate income tax rate (including resident surtax) is 14.85% after applying the 50% tax reduction rate. To become a designated venture company, a company must qualify as a small- and medium-sized enterprise under the Framework Act on Small- and Medium-Sized Enterprises and be found to have, among other things, a superior ability to provide innovation in technology and business by the Small and Medium Business Administration of Korea. Under the first prong of this test, a company that is engaged in data processing or computer-related business may qualify as a small- and medium-sized enterprise under the Framework Act on Small- and Medium-Sized Enterprises if, among other things, (i) it hires less than three hundred full-time employees or (ii) the total revenue of such company does not exceed W30 billion. In 2004, we failed to satisfy both of these tests. However, even if a company fails to satisfy both of the preceding requirements, it will continue to enjoy its status as a small- and medium-sized enterprise for the following three years so long as that company neither (x) merges into, nor consolidates with, another company nor (y) becomes an affiliate of certain large enterprise. Accordingly, we will continue to qualify as a small- and medium-sized company through 2007 if we neither merge into, nor consolidate with, another company nor become affiliated with large enterprises under Korean law.

The second prong of this test involves evaluation and due diligence of non-financial criteria such as adequacy of human resources, technological superiority, business plan and prospects, industry prospects, marketing strategy and plan, organizational information and management. The non-financial criteria of determining and declaring a company as a designated venture company may involve subjective judgment. A designated venture company, including us, must qualify every two years based on the evaluation described above. As the Company was designated as a venture company in September 2005, we will be able to enjoy this preferential treatment through 2006, after which we will be subject to the normal corporate tax rate without the 50% reduction.

To the extent we derive revenues from countries other than Korea, we may be subject to income withholding in those countries in which our products, including online games, are distributed. Such withholding taxes are included under income tax expenses. Withholding of such taxes is done by our overseas licensees at the current withholding rates in such countries. The effective withholding tax rates in our major overseas markets are 10% in Japan and China, 20% in Taiwan and 15% in Thailand. To the extent Korea has a tax treaty with any such country, withholding rates prescribed by such tax treaty apply. Under the Corporation Tax Law of Korea, we are entitled to, and recognize, a tax credit computed based on the amount of income withheld overseas when filing our income tax return in Korea, up to a limited amount. Accordingly, the amount of taxes withheld overseas may be offset against taxes payable in Korea. Adverse changes in tax treaties between Korea and the countries from which we receive license fees and royalties or

adverse changes in Korean tax law that prevent us from recognizing tax credits for taxes withheld overseas could materially and adversely affect our net income.

Recent Accounting Changes

No material change.

Table of Contents**Critical Accounting Policies**

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates, judgments and assumptions that affect the reported amounts of assets and liabilities, contingent liabilities, and revenue and expenses during the reporting period. We evaluate our estimates on an ongoing basis based on historical experience and other assumptions we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. The policies discussed below are considered by our management to be critical because they are not only important to the portrayal of our financial condition and results of operations but also because application and interpretation of these policies require both judgment and estimates of matters that are inherently uncertain and unknown. As a result, actual results may differ materially from our estimates.

Revenue recognition

We derive, and expect to continue to generate, most of our revenues from online game subscription fees paid by users in Korea, and royalties and license fees paid by our licensees in the overseas markets. Our revenues can be classified into the following four categories: (i) online games subscription revenue; (ii) online games royalties and license fees; (iii) mobile games; and (iv) character merchandising, animation and other revenue. For details, see " Overview Revenue recognition .

We recognize revenue in accordance with accounting principles generally accepted in the United States, as set forth in Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition*, and other related pronouncements.

Allowances for doubtful accounts

We maintain allowances for doubtful accounts receivable for estimated losses that result from the inability of our customers to make required payments. We base our allowances on the likelihood of recoverability of accounts receivable based on past experience and current collection trends. Allowances for accounts receivable generally arise when individual PC account subscribers who elect to make their payments through their fixed-line or mobile phone service provider fail to make such payment. We record allowances for doubtful accounts based on historical payment patterns of our customers and increase our allowances as the length of time such receivables become past due increases.

We use the services of several collection agencies to facilitate and manage the collection of our accounts receivables. Effective July 1, 2003, we changed our arrangement with these collection agencies so that we no longer assume any collection risk.

Capitalized software development costs

We account for capitalized software development costs in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Software development costs incurred prior to the establishment of technological feasibility are expensed when incurred and treated as research and development, or R&D, expenses. Once the game has reached technological feasibility, all subsequent software development costs for that product are capitalized until it is released for sale. Technological feasibility is evaluated on a product-by-product basis, but typically occurs once the online game has a proven ability to operate on a massively multi-player level. After the game is commercially released, the capitalized product development costs are amortized and expensed over the game s estimated useful life, which is deemed to be three years. This expense is recorded as a component of cost of revenues.

We evaluate the recoverability of capitalized software development costs on a product-by-product basis. Capitalized costs for those products whose further development or sale is terminated are expensed in the period of cancellation. In addition, a charge to cost of revenues is recorded when management s forecast for a particular game indicates that unamortized capitalized costs exceed the net realizable value of that asset.

Significant management judgments and estimates are required to assess the timing of technological feasibility as well as the ongoing recoverability of capitalized costs.

Table of Contents**Income taxes**

We account for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes*. Under SFAS No. 109, income taxes are accounted for under the asset and liability method.

Management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and the extent to which deferred tax assets can be recognized. A valuation allowance is provided for deferred tax assets to the extent that it is more likely than not that such deferred tax assets will not be realized. Realization of future tax benefits related to the deferred tax assets is dependent on many factors, including our ability to generate taxable income within the period during which the temporary differences reverse, the outlook for the economic environment in which the business operates, and the overall future industry outlook.

Based on our review of these factors, as of December 31, 2001 and 2002, we concluded that the historical losses presented sufficient evidence to require a full valuation allowance on the deferred tax assets. However, as of December 31, 2003, there was sufficient taxable income to support the reversal of this allowance.

As described in Overview Income tax expenses, we enjoyed in 2004 a reduced tax rate of 14.85%, which is 50% of the statutory tax rate and applied to certain designated venture companies. In 2005, while we will reapply for our designation as a venture company, it is uncertain as to whether we will obtain this designation. However, even if we cease to enjoy the 50% reduction in corporate income tax rate in 2005, we will instead be entitled to a special tax exemption of 10% in corporate income tax rate for the fiscal year 2005 by virtue of being a small- and medium-sized company. Accordingly, deferred income taxes as of December 31, 2004 were calculated based on the rate of 24.75% and 27.50% for the amounts expected to be realized during the fiscal year 2005 and 2006 and thereafter, respectively.

In September 2005, the Company was designated as a venture company and continues to enjoy a 50% reduction in the applicable corporate income tax rate in 2005 and expects to do so in 2006. Such benefit was not reflected in deferred income tax.

Results of Operations (as restated)**2004 Compared to 2003**

The following table summarizes our results of operations for the periods indicated.

	Year Ended December 31,			% Change
	2003 (Restated)	2004 (Restated)	2004⁽¹⁾ (Restated)	
	(In millions of Won and thousands of US\$)			
Revenues:			US	
Online games subscription revenue	₩ 18,560	₩ 16,253	\$16,732	(12.4)%
Online games royalties and license fees	29,727	45,101	46,429	51.7
Mobile games	43	376	387	N/M
Character merchandising, animation and other revenue	1,185	2,696	2,775	127.5
Total revenues	49,515	64,426	66,323	30.1
Cost of revenues	6,958	10,116	10,414	45.4
Gross profit	42,557	54,310	55,909	27.6
Gross profit margin ⁽²⁾	85.9%	84.3%	84.3%	
Operating expenses:				
Selling, general and administrative	11,360	13,660	14,062	20.2
Research and development	1,597	2,029	2,089	27.1
Total operating expenses	12,957	15,689	16,151	21.1

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Operating income	29,600	38,621	39,758	30.5
Operating profit margin ⁽³⁾	59.8%	59.9%	59.9%	
Other income (expense):				
Interest income	94	479	493	409.6
Interest expense	(6,465)	(4,732)	(4,871)	(26.8)
Foreign currency gains	413	430	442	4.1
Foreign currency losses	(278)	(1,055)	(1,086)	279.5
Others, net	26	(1)	(1)	N/M
Total net other expense	(6,210)	(4,879)	(5,023)	(21.4)
Income before income tax expenses, minority interest, and equity in loss of related joint venture	23,390	33,742	34,735	44.3
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	Year Ended December 31,			% Change
	2003	2004	2004 ⁽¹⁾	
	(Restated)	(Restated)	(Restated)	
	(In millions of Won and thousands of US\$)			
Income tax expenses	4,250	5,406	5,565	27.2
Income before minority interest and equity in loss of related joint venture	19,140	28,336	29,170	48.0
Minority interest ⁽⁴⁾		(17)	(18)	N/M
Equity in loss of related joint venture ⁽⁵⁾		296	305	N/M
Net income (loss)	₩ 19,140	₩ 28,057	US\$ 28,883	46.6%

*N/M = not
meaningful*

Notes:

- (1) For convenience, the Won amounts are expressed in U.S. dollars at the rate of ₩971.4 to US\$1.00, the noon buying rate in effect on March 31, 2006, as announced by the Federal Reserve Bank of New York.
- (2) Gross profit margin is calculated as gross profit divided by total revenues.
- (3) Operating profit margin is calculated as operating income divided by total revenues.
- (4) Represents the minority interest in GRAVITY Entertainment Corporation, our Japanese subsidiary. We acquired the remaining 50% of voting equity interest in RO Production in October 2004, resulting in RO Production becoming our wholly-owned subsidiary.
- (5) Represents the losses from our 30% equity investment in Animation Production Committee, a Japanese joint venture to produce and market Ragnarok the Animation through GRAVITY Entertainment Corporation, our Japanese subsidiary. This investment was accounted for using the equity method of accounting.

Revenues

Our total revenues increased by 30.1% to ₩64,426 million (US\$66,323 thousand) in 2004 from ₩49,515 million in 2003, primarily due to:

an increase in royalties and license fees from Ragnarok Online to ₩45,101 million (US\$46,429 thousand) in 2004 from ₩29,727 million in 2003, which primarily resulted from an increase in royalties from the overseas markets in which Ragnarok Online had already been commercialized and the commercialization of Ragnarok Online in new markets. During the periods under review, the increase in revenue attributable to existing markets was ₩13,795 million and attributable to an entry into new markets was ₩1,579 million. In April 2004, we commercialized Ragnarok Online in Singapore and Malaysia, from which we derived revenue of ₩1,103 million, and in the five European countries in April 2004, from which we derived revenue of ₩441 million, in each case in 2004. In December 2004, we commercialized Ragnarok Online in Australia and New Zealand, from which we derived revenue of ₩35 million in 2004; and

a 127.5% increase in character merchandising, animation and other revenue to ₩2,696 million (US\$2,775 thousand) in 2004 from ₩1,185 million in 2003, which resulted primarily from a 72.9% increase in character merchandising revenue to ₩2,028 million (US\$2,088 thousand) in 2004 from ₩1,173 million in 2003, a

2,330.77% increase in technical support revenue to ₩316 million (US\$325 thousand) from ₩13 million in 2003 and ₩247 million (US\$254 thousand) in revenue from animation in 2004 compared to none in 2003;

which more than offset

a 12.4% decrease in subscription revenue to ₩16,253 million (US\$16,732 thousand) in 2004 from ₩18,560 million in 2003. This 12.4% decrease resulted primarily from a 21.4% decrease in subscription revenue in Korea from Ragnarok Online to ₩12,724 million (US\$13,099 thousand) in 2004 from ₩16,186 million in 2003, mainly due to a decrease in playing time by our users of Ragnarok Online in Korea. This decrease was partially offset by a 48.7% increase in the subscription revenue in the United States to ₩3,528 million (US\$3,632 thousand) in 2004 from ₩2,373 million in 2003.

Cost of revenues

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Our cost of revenues increased by 45.4% to ₩10,116 million (US\$10,414 thousand) in 2004 from ₩6,958 million in 2003, which was primarily due to:

a 63.4% increase in salaries and wages to ₩4,403 million (US\$4,533 thousand) in 2004 from ₩2,695 million in 2003, which mainly resulted from an increased hiring of game developers and overseas support staff from 130 as of December 31, 2003 to 174 as of December 31, 2004;

a 58.4% increase in fee payments to ₩1,893 million (US\$1,949 thousand) in 2004 from ₩1,195 million in 2003, which mainly resulted from an increase in fees we paid to Mr. Myoung-Jin Lee and server housing fees we paid to the KIDC; and

a 41.5% increase in depreciation to ₩1,559 million (US\$1,605 thousand) in 2004 from ₩1,102 million in 2003, which mainly resulted from the addition of servers and software in 2004 to better service Ragnarok Online.

Gross profit and margin

As a result of the foregoing, our gross profit increased by 27.6% to ₩54,310 million (US\$55,909 thousand) in 2004 from ₩42,557 million in 2003. Our gross profit margin decreased to 84.3% in 2004 from 85.9% in 2003.

Operating expenses

Selling, general and administrative expenses. Our selling, general and administrative expenses increased by 20.2% to ₩13,660 million (US\$14,062 thousand) in 2004 from ₩11,360 million in 2003, primarily due to:

a 81.6% increase in salaries and wages to ₩3,156 million (US\$3,249 thousand) in 2004 from ₩1,738 million in 2003, primarily as a result of an increase in the number of employees for administrative and other support functions from 86 in 2003 to 148 in 2004;

a 174.7% increase in depreciation expense to ₩989 million (US\$1,018 thousand) in 2004 from ₩360 million in 2003, which mainly resulted from depreciation attributable to leasehold improvements in property and the addition of servers for the introduction of R.O.S.E. Online; and

a 9.0% increase in advertising expenses to ₩4,614 million (US\$4,750 thousand) in 2004 from ₩4,233 million in 2003, which resulted from the hosting of the Ragnarok World Championship in August 2004, a significant increase in marketing expenses related to the introduction of R.O.S.E. Online and our participation in the Tokyo Game Show in September 2004.

Research and development expenses. Our research and development expenses increased 27.1% to ₩2,029 million (US\$2,089 thousand) in 2004 from ₩1,597 million in 2003, primarily due to expensing of all costs, including salaries and wages, and provision for severance indemnities, relating to the development of Requiem and Ragnarok Online 2.

Operating income and operating margin

As a result of the cumulative effects of the reasons stated above, our operating income increased 30.5% to ₩38,621 million (US\$39,758 thousand) in 2004 from ₩29,600 million in 2003, and our operating margin improved to 59.9% in 2004 from 59.8% in 2003.

Net other income (expense)

Our net other expense decreased 21.4% to ₩4,879 million (US\$5,023 thousand) in 2004 from ₩6,210 million in 2003 primarily due to:

a 26.8% decrease in interest expense from ₩6,465 million in 2003 to ₩4,732 million (US\$4,871 thousand) in 2004 as a result of reduction in payment rates on the loan from Sunny YNK, effective in March 2003, from 50% of all revenues from Ragnarok Online to 20% for domestic adjusted revenues and to 10% for overseas adjusted revenues from Ragnarok Online despite the significant increase in such revenues; and

an increase in interest income from ₩94 million in 2003 to ₩479 million (US\$493 thousand) in 2004 resulting from

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an increase in short-term financial instruments in 2004

which more than offset

an increase in loss in foreign currency transaction from ₩278 million in 2003 to ₩1,055 million (US\$1,086 thousand) in 2004 resulting from the appreciation of the Korean Won against the U.S. dollar.

Income tax expenses

We recorded income tax expenses of ₩5,406 million (US\$5,565 thousand) in 2004, as compared to ₩4,250 million in 2003. Our income tax expenses increased as a result of an increase in our taxable income, in particular, royalties and license fees from revenues generated in overseas markets. In both 2003 and 2004, however, we were entitled to a reduced tax rate of 14.85% by virtue of the Special Tax Treatment Control Law of Korea.

Minority interest

Minority interest represents the net loss from GRAVITY Entertainment Corporation, our Japanese subsidiary, which is attributable to the third-party minority interest holders. In October 2004, we acquired the remaining minority interest in GRAVITY Entertainment Corporation.

Equity in loss of related joint venture

Equity in loss of related joint venture represents the 30% of the net loss incurred from Animation Production Committee, the Japanese animation joint venture in which we, through GRAVITY Entertainment Corporation, our Japanese subsidiary, made a 30% equity investment. This investment was accounted for using the equity method of accounting.

Net income

As a result of the cumulative effects of the reasons stated above, our net income increased 46.6% to ₩28,057 million (US\$28,883 thousand) in 2004 from ₩19,140 million in 2003.

2003 Compared to 2002

The following table summarizes our results of operations for the periods indicated.

	Year Ended December 31,		
	2002	2003	%
	(Restated)	(Restated)	Change
	(In millions of Won and thousands of US\$)		
Revenues:			
Online games subscription revenue	₩ 7,310	₩ 18,560	153.9%
Online games royalties and license fees	2,330	29,727	1,175.8
Mobile games		43	N/M
Character merchandising, animation and other revenue	427	1,185	177.5
Total revenues	10,067	49,515	391.9
Cost of revenues	1,738	6,958	300.3
Gross profit	8,329	42,557	410.9
Gross profit margin ⁽¹⁾	82.7%	85.9%	
Operating expenses:			
Selling, general and administrative	4,870	11,360	133.3
Research and development	815	1,597	96.0
Total operating expenses	5,685	12,957	127.9
Operating income	2,644	29,600	1,019.5

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Operating profit margin ⁽²⁾	26.3%	59.8%	
Other income (expense):			
Interest income	84	94	11.9
Interest expense	(2,583)	(6,465)	150.3
Foreign currency gains	93	413	344.1
Foreign currency losses	(17)	(278)	1,535.3
Others, net	(1)	26	N/M
Total net other expense	(2,424)	(6,210)	156.2

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	Year Ended December 31,		%
	2002	2003	
	(Restated)	(Restated)	
	(In millions of Won and thousands of US\$)		
Income before income tax expenses	220	23,390	N/M
Income tax expenses	542	4,250	684.1
Net income (loss)	₩ (322)	₩ 19,140	N/M

N/M = not meaningful.

Notes:

(1) Gross profit margin is calculated as gross profit divided by total revenues.

(2) Operating profit margin is calculated as operating income (loss) divided by total revenues.

Revenues

Our total revenues increased by 391.9% to ₩49,515 million in 2003 from ₩10,067 million in 2002, primarily due to:

an increase in royalties and license fees from Ragnarok Online to ₩29,727 million in 2003 from ₩2,330 million in 2002, which primarily resulted from substantial increases in royalties from overseas markets, primarily due to the full year of commercial availability of Ragnarok Online in Taiwan and Japan in 2003 as compared to only a few months in 2002 and generation of revenues from markets we newly entered in 2003, mainly Thailand and China; and

a 153.9% increase in subscription revenue, primarily representing the increase in domestic subscriptions from Ragnarok Online, which reflects the recording of revenues from Ragnarok Online for the full year of 2003 as compared to five months in 2002 following the commercial launch of Ragnarok Online in August 2002.

Cost of revenues

Our cost of revenues increased by 300.3% to ₩6,958 million in 2003 from ₩1,738 million in 2002, which was primarily due to:

a 360.7% increase in salary and wages to ₩2,695 million in 2003 from ₩585 million in 2002 resulting from an increase in the number of game developers and overseas support staff from 92 in 2002 to 130 in connection with significant hiring for game development and support;

a 753.6% increase in fee payments to ₩1,195 million in 2003 from ₩140 million in 2002, which mainly resulted from increases in fees payable to Mr. Myoung-Jin Lee, Web hosting costs, server housing fees to KIDC and software maintenance costs; and

a 161.1% increase in depreciation to ₩1,102 million in 2003 from ₩422 million in 2002, which mainly resulted from the purchase of servers and, to a lesser extent, personal computers in 2003.

Gross profit and margin

As a result of the foregoing, our gross profit increased by 410.9% to ₩42,557 million in 2003 from ₩8,329 million in 2002. Our gross profit margin increased to 85.9% in 2003 from 82.7% in 2002.

Operating expenses

Selling, general and administrative expenses. Our selling, general and administrative expenses increased by 133.3% to ₩11,360 million in 2003 from ₩4,870 million in 2002, primarily due to:

a 217.3% increase in advertising expenses to ₩4,233 million in 2003 from ₩1,334 million in 2002, which mainly resulted from the introduction of increased marketing campaigns, including online and celebrity

marketing;

a 111.4% increase in fee payments consisting of fees paid to payment service providers and sales commissions paid to promotional agents distributing Ragnarok Online to Internet cafés to ₩2,602 million in 2003 from ₩1,231 million in 2002, primarily due to an increase in revenue in Korea;

a 119.7% increase in salaries and wages to ₩1,738 million in 2003 from ₩791 million in 2002, primarily as a result

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of increase in the average number of employees during the periods under review; and

our recording an impairment loss of ₩777 million in 2003, resulting from our ₩1 billion cash investment in an online game portal business in May 2003. In December 2003, due to poor performance and operating results, we sought to nullify the investment arrangement and recovered ₩223 million in cash and recorded the remaining ₩777 million as impairment loss.

Research and development expenses. Since technological feasibility had not yet been reached with respect to R.O.S.E. Online, Requiem and Ragnarok Online 2, our research and development expenses increased 96.0% to ₩1,597 million in 2003 from ₩815 million in 2002, primarily due to expensing of all costs, including salaries and wages and provision for severance indemnities, relating to the licensing of R.O.S.E. Online and development of Ragnarok Online 2 and Requiem.

Operating income and operating profit margin

As a result of the cumulative effects of the reasons stated above, we recorded operating income of ₩29,600 million in 2003, as compared to operating income of ₩2,644 million in 2002, and our operating margin improved to 59.8% in 2003 from 26.3% in 2002.

Net other expense

Our net other expense increased 156.2% to ₩6,210 million in 2003 from ₩2,424 million in 2002 primarily due to a 150.3% increase in interest expense to ₩6,465 million in 2003 from ₩2,583 million, resulting primarily from a 144.6% increase in payments to Sunny YNK to ₩6,256 million in 2003 from ₩2,558 million, which are linked to our revenues based on Ragnarok Online, which significantly increased in 2003 compared to 2002 as described above. See Overview Foreign currency effects .

Income tax expenses

Our income tax expenses increased as a result of an increase in our taxable income. In 2003, however, we were entitled to a reduced tax rate of 14.85% by virtue of the Special Tax Treatment Control Law of Korea. Applying this reduced tax rate, we recorded income tax expenses of ₩4,250 million in 2003.

Net income (loss)

As a result of the cumulative effects of the reasons stated above, we recorded net income of ₩19,140 million in 2003, as compared to net loss of ₩322 million in 2002.

Impact of inflation

In view of our brief operating history, we believe that inflation in Korea and our other principal markets has not had a material impact on our results of operations. Inflation in Korea was 4.1% in 2001, 2.7% in 2002, 3.6% in 2003 and 3.6% in 2004.

Impact of foreign currency fluctuations

See Item 11 Quantitative and Qualitative Disclosures about Market Risk .

Government, Economic, Fiscal, Monetary or Political Policies or Factors

See Item 3.D. Risk Factors Risks Related to The Republic of Korea , Item 4.B. Business Overview Laws and Regulations and Item 10.E. Taxation .

5.B. Liquidity and Capital Resources

Liquidity

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

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	Year Ended December 31,				
	2001	2002	2003	2004	2004 (US\$)
		(restated)	(restated)	(restated)	(restated)
Cash and cash equivalents at beginning of period	₩ 39	₩ 1,820	₩ 560	₩ 5,405	US\$ 5,564
Net cash provided by (used in) operating activities	922	(4,299)	15,823	32,642	33,603
Net cash used in investing activities	(589)	(3,520)	(10,564)	(19,007)	(19,566)
Net cash provided by (used in) financing activities	1,448	6,559	(414)	(2,635)	(2,713)
Net increase (decrease) in cash and cash equivalents	1,781	(1,260)	4,845	11,000	11,324
Cash and cash equivalents at end of period	₩ 1,820	₩ 560	₩ 5,405	₩ 16,405	US\$ 16,888

Note:

(1) For convenience, the Korean Won amounts are expressed in U.S. dollars at the rate of ₩971.4 to US\$1.00, the noon buying rate in effect on March 31, 2006 as quoted by the Federal Reserve Bank of New York.

Prior to the commercial launch of Ragnarok Online, our principal sources of liquidity were cash from equity financing and incurrence of debt, including the debt we incurred from Sunny YNK. Following the commercial launch of Ragnarok Online, our principal sources of liquidity have been cash flows from our operating activities and equity financing and, to a lesser extent, short-term borrowings. Net cash used in investing activities have consisted primarily of investments in game engines, network servers and, to a lesser extent, personal computers. As a result, our net property and equipment increased from ₩5,417 million as of December 31, 2003 to ₩14,760 million (US\$15,195 thousand) as of December 31, 2004.

In order to resolve short-term liquidity issues that may arise from time to time in the course of our business, we have in the past obtained short-term borrowings at market rates from other game developers. In February 2003, we obtained a loan of ₩3 billion at an annual interest rate of 18% from IAMBiz Co., Ltd., which subsequently changed its name to Rhoceo Co., Ltd., to satisfy short-term liquidity needs relating to marketing and promotional activities for Ragnarok Online and for working capital. In September 2003, we fully repaid this loan with positive cash flow generated by Ragnarok Online. Since then, we have not incurred any additional short-term borrowing and no short-term borrowings were outstanding as of December 31, 2004. In order to resolve long-term liquidity issues, we have traditionally resorted to the issuance of equity securities such as the rights offering that we conducted in March 2003. In 2002, in order to resolve long-term liquidity issues prior to the commercial launch of Ragnarok Online, we entered into an exclusive distribution agreement with Sunny YNK pursuant to which we received a lump sum payment in the amount of ₩7,000 million at the inception of the agreement, which we recorded as debt on our balance sheet. Since then, we have been able to satisfy our liquidity needs with cash flow from operations and do not expect to enter into such arrangements in the future. Our cash investment policy emphasizes liquidity and preservation of principal over other portfolio considerations. We deposit our cash in demand deposits, short-term financial instruments, which primarily consist of time deposits with maturity of one year or less, and money market funds with a rolling maturity of 90 days or less. Our short-term financial instruments increased from nil as of December 31, 2002 to ₩1,600 million as of December 31, 2003 and to ₩8,900 million (US\$9,162 thousand) as of December 31, 2004.

primarily as a result of increased net cash from our operations during the period.

Cash received in the form of initial license fees are recognized as revenues on a monthly basis over the life of our license agreements as described in Item 5.A. **Overview Revenue recognition** . The portion of initial license fees not yet recognized as revenues are reflected in our balance sheet as deferred income. Our total deferred income, both short-term and long-term, increased from ₩2,750 million as of December 31, 2002 to ₩4,258 million as of December 31, 2003 and to ₩7,597 million (US\$7,821 thousand) as of December 31, 2004 primarily due to our recognizing an increased portion of initial license fees that we received in 2002, 2003 and 2004 as revenues.

Cash flows from operating activities. Our increase in net cash provided by operating activities from 2001 to 2004 was primarily the result of our recording net income in 2003 and 2004 compared to net losses in 2001 and 2002. Our increase in net cash provided by operating activities in 2003 also reflected an adjustment of ₩1,619 million for depreciation and amortization. This increase was partially offset by ₩912 million in deferred income taxes that we recorded in 2003. Our increase in net cash provided by operating activities in 2004 reflected an adjustment of ₩3,217 million (US\$3,312 thousand) for depreciation and amortization, of ₩3,339 million (US\$3,437 thousand) for deferred income from the renewal of sales contract, and of ₩913 million (US\$940 thousand) for provision for accrued severance benefits. This increase was partially offset by ₩1,156 million (US\$1,190 thousand) in deferred income taxes that we recorded in 2004. The increases in deferred expense and accounts payable on our balance sheet as of December 31, 2004 primarily reflected the fees that we incurred in connection with our initial public offering on NASDAQ in the amount of ₩1,735 million (US\$1,786 thousand), which were unpaid as of December 31, 2004, and then paid in full in February and May 2005.

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Cash flows from investing activities. Our increase in net cash used in investing activities from 2001 to 2004 reflected purchases of property and equipment in these years in connection with the general growth of our businesses and the increase in payment of leasehold deposits. In addition, our net cash used in investing activities in 2003 and 2004 reflected our investment of our excess cash in short-term financial instruments in the amount of ₩2,200 million in 2003 and ₩7,300 million (US\$7,515 thousand) in 2004, investment of ₩1 billion in a game portal business and acquisition of golf membership in the amount of ₩892 million in 2003, and an investment of ₩1,243 million (US\$1,280 thousand) through our Japan subsidiary in the Animation Production Committee, a joint venture for the production and marketing of Ragnarok the Animation, in 2004. In March 2004, we entered into an agreement to purchase from Choongang Mutual Savings Bank an office building to house part of our headquarters for ₩8,150 million in cash, which has been fully paid.

Cash flows from financing activities. Our net cash provided by financing activities has been primarily affected by the issuance of common shares in 2003 and the incurrence of debt from Sunny YNK in 2002. In March 2003, we received net proceeds of ₩3,206 million from the sale of 2,148,900 common shares at ₩1,500 per share. Our net cash provided by financing activities in 2001 and 2002 consisted of proceeds from the issuances of common stock, consisting of 600,000 shares in January 2001, 1,200,000 shares in October 2001 and 600,000 shares in January 2002, each at ₩500 per share. In February and April 2002, we entered into agreements with Sunny YNK pursuant to which we granted it the exclusive right to distribute Ragnarok Online for a contractual period of three years from the date Ragnarok Online was first commercialized. In consideration, we received a lump sum payment in the amount of ₩7,000 million at the inception of these agreements, which we recorded as debt on our balance sheet.

Capital resources

As our overseas operations are conducted primarily through our subsidiaries and our overseas licensees, our ability to finance our operations and any debt that we or our subsidiaries may incur depends, in part, on the payment of royalties and other fees by our overseas licensees and, to a lesser extent, the flow of dividends from our subsidiaries.

As of December 31, 2004, our primary source of liquidity was ₩16,405 million (US\$16,888 thousand) of cash and cash equivalents. We believe that our available cash and cash equivalents and net cash provided by operating activities, will be sufficient to meet our capital needs for at least the next 12 months. However, we cannot assure you that our business or operations will not change in a manner that would consume available capital resources more rapidly than anticipated. We may, however, require additional cash resources due to changed business conditions or other future developments, including any significant investments or acquisitions. If these sources are insufficient to satisfy our cash requirements, we may seek to sell additional securities either in the form of equity or debt. In the past, we raised cash resources through the issuance of common shares. See note 11 to our audited consolidated financial statements as of December 31, 2003 and 2004 and for the years ended December 31, 2002, 2003 and 2004. The sale of additional equity securities or convertible debt securities could result in additional dilution to our shareholders. In the past, we also raised cash by entering into indebtedness arrangements such as the transaction entered into with Sunny YNK as described in Item 5.A. **Overview Interest expense** . In addition, we may seek to incur indebtedness through the issuance of debt securities or by obtaining a credit facility. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financial covenants that would restrict operations. As of December 31, 2004, we had no lines of credit or other credit facilities. We also have not entered into any material financial guarantees or similar commitments to guarantee the payment obligations of third parties. Financing may not be available in amounts or on terms acceptable to us, if at all.

We expect to have capital expenditure requirements for the ongoing expansion into other markets, including hardware expenditures for continuous expansions and upgrades to our existing server equipment, and also for game development, acquiring and publishing third party game developers or games developed by them and continuing to invest in enhancing our technological, marketing, distribution and service capabilities. We believe that our internal cash flow from operations, together with our proceeds from our initial public offering in February 2005 will be sufficient to satisfy our working capital requirements through at least the first quarter of 2006, including our new game development expenditures for Requiem and Ragnarok Online 2.

5.C. Research and Development, Patents and Licenses, etc.

See Item 5.A. **Business Overview Game development and publishing** for our research and development.

Our intellectual property is an essential element of our business operations. We rely on copyright, trademark, trade secret and other intellectual property law, as well as non-competition, confidentiality and license agreements with our employees, suppliers, licensees, business partners and others to protect our intellectual property rights. Our employees are generally required to sign agreements acknowledging that all inventions, trade secrets, works of authorship, developments and other

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processes generated by them on our behalf are our property, and assigning to us any ownership rights that they may claim in those works. With respect to copyrights and computer program rights created by our employees within their employment scope and which are made public bearing our name, we are not required to pay any additional compensation to our employees.

In developing Ragnarok Online, we obtained an exclusive license from Mr. Myoung-Jin Lee to use the storyline and characters from his cartoon titled Ragnarok for the production of online games, animation and character merchandising. See Item 4.B. Business Overview Our products Massively multiplayer online role playing games Massively multiplayer online role playing games currently offered Ragnarok Online above.

We are the registered owner of two registered software copyrights to Ragnarok Online and Arcturus, a PC-based game, each of which we have registered with the Program Deliberation and Mediation Committee of Korea. As of December 31, 2004, we owned over 32 registered domain names, including our official website and domain names registered in connection with each of the games we offer. We also had registered trademarks and trademark applications pending at patent and trademark offices in 15 countries covering eight discrete trademarks, two design patents and three analogous design patents, which are variations of the two design patents, registered with the Korea Intellectual Property Office, and registered copyrights covering 11 game characters, in each case as of December 31, 2004.

5.D. Trend Information

Trends, uncertainties and events which could have a material impact on our sales, operating revenues and liquidity and capital resources are discussed above in Item 5.A. Operating Results and Item 5.B. Liquidity and Capital Resources .

5.E. Off-Balance Sheet Arrangements

As of December 31, 2004, we did not have any outstanding derivative financial instruments, off-balance sheet guarantees, interest rate swap transactions or foreign currency forward contracts. We do not engage in trading activities involving non-exchange traded contracts. In 2005, we began entering into derivatives arrangements to hedge against the risk of foreign currency fluctuations. As of June 29, 2005, we had foreign currency forward contracts outstanding in the aggregate notional amount of US\$70 million. See Item 11 Quantitative and Qualitative Disclosures about Market Risk .

5.F. Contractual Obligations

We have financed our operations primarily through incurrence of debt from third parties, such as Sunny YNK, cash flows from operations as well as equity investments by our founder and current shareholders. The following table sets forth a summary of our contractual cash obligations due by period as of December 31, 2004.

	Payments Due by Period				Total
	Up to 1 Year	Between 1 and 3 Years	Between 3 and 5 Years	Beyond 5 Years	
	(In millions of Won)				
Long-term debt obligations	₩ 1,150	₩	₩	₩	₩ 1,150
Operating lease obligations	728	5			733
Purchase obligations ⁽¹⁾					
Total	₩ 1,878	₩ 5	₩	₩	₩ 1,883

Note:

(1) As of December 31, 2004, we incurred no purchase obligations.

Our long-term debt obligations represent the outstanding balance as of December 31, 2004 of the debt we incurred from Sunny YNK in 2002 pursuant to the transaction entered into with Sunny YNK as described in Overview Interest expense . All of this amount is due within one year since our agreement with Sunny YNK expires in July 2005, at which time we expect all of the principal amount to have been repaid and we will no longer be obligated to make payments to Sunny YNK. As there is no interest rate stated in the agreement with Sunny YNK, the interest is imputed based on the difference between the principal amount of the loan and the total payments expected to be made pursuant to the agreement. Accordingly, the repayment of principal balance to Sunny YNK is variable each year in accordance with the amount of annual revenue generated from distribution of RAGNAROK and deduction of annual interest expense allocated using the interest rate method. We do not plan to extend or renew this arrangement.

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Our contractual cash obligations consist of operating leases for office space. The lease payments due by December 31, 2005 will be ₩678 million, ₩23 million and ₩27 million for our principal offices in Seoul, U.S. subsidiary and Japan subsidiary respectively. The lease terms expire December 2005, April 2005 and February 2006 for our principal offices in Seoul, U.S. subsidiary and Japan subsidiary respectively. The renewal terms are subject to market conditions.

For a description of our commercial commitments and contingent liabilities, see Note 9 of the notes to our consolidated financial statements.

As of December 31, 2004, we had no lines of credit or other credit facilities. We also have not entered into any material financial guarantees or similar commitments to guarantee the payment obligations of third parties.

For a description of our legal proceedings, see Item 8 Financial Information Legal Proceedings.

PART II

ITEM 15. CONTROLS AND PROCEDURES

Background to Restatement

In November 2005, the audit committee of the board of the directors of the Company (the Audit Committee) determined that the Company's audited consolidated financial statements as of December 31, 2003 and 2004 and for each of the years ended December 31, 2002, 2003 and 2004 (the Original Financial Statements) needed to be restated. The need for a restatement arose from the discovery and subsequent investigation by the Audit Committee (the Investigation) of the diversion of revenues payable to the Company from certain licensees of its Ragnarok Online game to the former Chairman and former controlling shareholder of the Company, Mr. Jung Ryool Kim (the former Chairman). The impact of the diversion was that such revenues were improperly omitted from the Original Financial Statements.

In January 2006, the Audit Committee, with the assistance of its special Korean counsel, Woo Yun Kang Jeong & Han (Woo Yun), its special United States counsel, Cleary Gottlieb Steen & Hamilton LLP and Deloitte Anjin LLC (Deloitte), which was hired by Woo Yun to assist it on accounting matters, completed the Investigation. On January 23, 2006, the Audit Committee presented to the Company's board of directors and senior management, the final investigation reports of Woo Yun and Deloitte, which summarized the results of the Investigation (the Investigation Reports).

The conclusions set forth in the reports address the following areas that resulted in a restatement of the Original Financial Statements: (i) that the former Chairman of the company systematically diverted certain payments that were due to the company from the licensing of its Ragnarok Online game by instructing licensees to pay such amounts to bank accounts that were fraudulently established in the Company's name or established in the name of other Company's that were under the control of the former Chairman. This diversion resulted in an understatement of revenue in the original financial statements; (ii) expenses incurred by the Company for the purchase of certain assets that were recorded as fixed assets of the company but were actually acquired for the personal benefit of the former Chairman. This improper use of the Company's funds resulted in fixed assets and related depreciation being improperly recorded in the original financial statements; and (iii) the improper and intentional early recognition of certain revenue in connection with the Company's mobile games revenue and character merchandising, animation and other revenue in the year ended December 31, 2004. This intentional manipulation of recorded revenue resulted in revenue being recorded for the year ended December 31, 2004 that should have been deferred and subsequently recognized in 2005.

Based on the results of the Investigation, the Audit Committee recommended to the Company's board of directors, and the board of the directors resolved that the Company will restate the Original Financial Statements, reflecting certain of the material findings in the Investigation Reports, as soon as practicable, with the assistance of a Korean affiliate of a major international accounting firm, which was hired by the Company as a consultant to assist it in preparing the Restated Financial Statements under accounting principles generally accepted in the United States, or U.S. GAAP.

The Company has completed the preparation of the Restated Financial Statements, which it is filing as Exhibit 18 to this Amendment No. 1 to our 2004 Annual Report on Form 20-F. As discussed in Note 2 of the Notes to the Restated Financial Statements, the Company's consolidated balance sheets as of December 31, 2003 and 2004 and its consolidated statements of operations, cash flows and change in shareholders' equity for 2002, 2003 and 2004 have

been restated from the Original Financial Statements. Restatement adjustments are further described in Note 2 of the Notes to the Restated Financial Statements.

Disclosure Controls and Procedures

At the time of the filing of our Annual Report on Form 20-F for the year ended December 31, 2004, our then Chief Executive and Chief Financial Officers concluded that the design and operation of our disclosure controls and procedures as of December 31, 2004 were effective. In connection with the preparation of the Restated Financial Statements and the preparation and filing of this Amendment No. 1, the Company, under the supervision and with the participation of the Company's current management, including the Company's Chief Executive Officer (the "CEO") and Chief Financial Officer (the "CFO") (the CEO and the CFO, collectively, the "Certifying Officers") in consultation with the Company's accounting and other management team, carried out an evaluation of the effectiveness of its disclosure controls and procedures (as the term is defined in the Exchange Act Rules 13a-15(e) and 15d-15(e)) as those controls existed as of December 31, 2004. As defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Exchange Act, as amended, the term "disclosure controls and procedures" means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow

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timely decisions regarding required disclosure. Based on this evaluation, the CEO and the CFO have concluded that the Company's disclosure controls and procedures were not effective.

Material Weaknesses in Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Exchange Act Rule 13a-15(f). Because of its inherent limitations, internal control over financial reporting may not prevent or detect all misstatements. A material weakness as defined under the Standards of the Public Accounting Oversight Board (United States) is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Management identified the following material weaknesses in our internal control over financial reporting (as defined under Standards of the Public Accounting Oversight Standard Board (United States) as of December 31, 2004.

We did not maintain an effective control environment. Specifically, the Company did not maintain a control environment adequate to encourage the prevention or detection of the override of our controls or intentional misconduct, including the embezzlement of revenues due to the Company, improper payment for assets not otherwise purchased for the benefit of the Company, the intentional and inappropriate early recognition of revenue and the preparation of false management reports, accounting records, financial statements and documents together with forged invoices. The absence of effective control environment allowed the former Chairman to take inappropriate actions that resulted in certain transactions not being properly reflected in our consolidated financial statements for the years ended December 31, 2002, 2003 and 2004. Such intentional misconduct by the former Chairman included the preparation of false accounting records and documents to deceive accounting personnel under his supervision, other members of senior management, our Board of Directors and our independent registered public accountants. Additionally, the lack of an effective control environment allowed our lines of communication among, and our monitoring of, our operations and accounting personnel, including the former Chairman, to be ineffective in preventing or detecting these instances of intentional misconduct. Taken as a whole, our control environment did not adequately emphasize appropriate judgment, skepticism and objectivity, which the Company believes contributed to the events which necessitated the restatements.

This control environment material weakness contributed to the fraudulent activity described above, which in turn resulted in the restatement of our consolidated financial statements for the years ended December 31, 2004, 2003 and 2002 and adjustments to our 2005 consolidated financial statements. Additionally, this control environment material weakness could result in misstatements of any of our financial statement accounts that would result in a material misstatement to the annual consolidated financial statements that would not be prevented or detected. Accordingly, our management has determined that this control deficiency constitutes a material weakness. This material weakness in our control environment contributed to the existence of the following additional material weaknesses:

Lack of independent oversight and supervision controls. The Company's Audit Committee and the system of internal control over financial reporting established by the Audit Committee failed to recognize and detect the fraudulent activities by the former Chairman and certain member of the senior management. The Company did not have adequate controls related to the prevention and detection of fraud, for example, corporate compliance programs and whistleblower hotlines.

Lack of controls over the reported revenues from our overseas licensees. The Company did not have controls designed to detect under-reporting of amounts due to the Company by overseas licensees.

Lack of controls over bank accounts. The former Chairman was able to open overseas bank accounts, with the help of a Company employee without appropriate monitoring, which contributed to the former Chairman's ability to carry on fraudulent activities without being detected. In addition, the former Chairman had access to the Company's accounts without oversight, which allowed him to use Company accounts and transfer funds out of such accounts without proper authorization.

Lack of sufficient complement of personnel. The Company did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the selection, application and implementation of U.S. GAAP commensurate with the Company's financial reporting requirements under the Exchange Act.

Lack of controls over the purchase and accounting for fixed assets. The Company did not have adequate authorization controls to ensure that assets purchased and paid for by the Company were in fact for the benefit of the Company and did not have adequate controls to verify and ensure that assets recorded in the Company's balance sheet were in fact in possession of the Company.

Lack of controls over the financial close and reporting process. We did not maintain effective controls, including monitoring, over our financial close and reporting process. Specifically, we do not have adequately designed controls to ensure the completeness, accuracy and restricted access to spreadsheets used in the period-end financial closing process. This control deficiency could result in errors in the performance of consolidations and the preparation of U.S. GAAP financial statements and allow our employees manipulate financial results and override controls.

The control deficiencies described above resulted in the restatement of the Company's consolidated financial statements for the years ended December 31, 2004, 2003 and 2002 and adjustments to our 2005 consolidated financial statements. Additionally, each of the control deficiencies described above could result in a misstatement in any of our financial statement accounts or disclosures that would result in a material misstatement in the Company's consolidated financial statement that would not be prevented or detected. Accordingly, the Company's management has determined that each of these control deficiencies constitute material weaknesses.

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Remediation of Material Weaknesses

The Company's management is committed to addressing the material weaknesses identified above by implementing various remedial measures to the Company's internal control over financial reporting. During the year ended December 31, 2005 and to the date of the filing of this Amendment No. 1, our management, including the Certifying Officers and the Audit Committee, have executed a range of actions to address the material weaknesses in our internal control over financial reporting, including implementing the following:

Change in oversight. We have, since the discovery of the events which led to the Investigation, replaced the members of the Audit Committee in its entirety with three new independent directors and have terminated or removed from office those individuals the Company believes were responsible for the actions which led to the Investigation. In addition, we have created a new position of chief compliance officer, whose mandate is to ensure that the Company's policies regarding ethics is strictly enforced and to put in place a culture of accountability and independent monitoring to address any potential for such failures happening in the future, including for example the audit and review of database entries of the Company's major licensees. The chief compliance officer (CCO) reports to both the CEO and to the Audit Committee.

Retain outside consulting firm. We retained the consulting services of a Korean affiliate of a major international accounting firm in June 2005 to enhance our internal control system and to develop an evaluation system to enable our management to evaluate the effectiveness of our internal control over financial reporting (as defined under Rules 13a-15(c) and 15d-15(c) under the Exchange Act) and to assist the Company in the preparation of its financial statement under U.S. GAAP. The accounting firm has recommended various remedial measures and the Company along with our senior management and accounting team are in the process of implementing such recommendations.

Software and systems upgrade. We are in the process of implementing an enterprise resource program, or ERP, with the ultimate aim to provide to senior management integrated and timely reporting of the Company's financial results and financial condition while minimizing the ability to override established protocols. In addition, the aim of the ERP system will be to segregate duties of various persons and departments to help minimize unauthorized actions and to provide a check to ensure that any irregularities are detected and reported in a timely manner. Also, the Company believes that such a system will minimize errors which were more likely when the Company relied on spreadsheet programs. The Company is in the process of implementing such system and expects to have the system operational by the end of 2006.

Code of ethics. The Company has recently amended its code of ethics to emphasize the need for senior management and all of the employees of the Company to comply with the ethics standards as set forth in the Company's code of ethics. All new employees are to receive training on the code of ethics. Also, the code of ethics includes a whistle blower process, whereby employees can communicate on an anonymous basis with the CCO or CEO, who are to report such matters to any member of the Audit Committee regarding fraudulent or suspicious activities.

The Company's management, in particular, its CEO and CFO along with the Audit Committee, is in the process of addressing the material weaknesses and will seek to put in place a system of internal control over financial reporting which will remediate such material weaknesses as expeditiously as possible. All disclosure controls and procedures, no matter how well designed, however, have inherent limitations including the possibility of human error and the circumvention or overriding of the controls and procedures. A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of

the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect all misstatements.

Changes In Internal Control Over Financial Reporting

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There were no changes in the Company's internal control over financial reporting, as that term is defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Exchange Act that occurred during the year ended December 31, 2004 that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting. However, in connection with the material weaknesses in internal control over financial reporting discussed above, the Company is currently in the process of taking remedial measures described above to address the material weaknesses.

PART III**ITEM 18. FINANCIAL STATEMENTS**

Reference is made to Item 19. Exhibits for a list of all financial statements and schedules filed as part of this Amendment No. 1.

ITEM 19. EXHIBITS**(a) Financial Statements filed as part of this Amendment No. 1**

The following financial statements and related schedules, together with the reports of independent accountants thereon, are filed as part of this Amendment No. 1:

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Index to Financial Statements	F-1
Report of Independent Registered Public Accounting Firm	F-2
Consolidated balance sheets as of December 31, 2003 and 2004	F-3
Consolidated statements of income for the years ended December 31, 2002, 2003 and 2004	F-4
Consolidated statements of stockholders' equity for the years ended December 31, 2002, 2003 and 2004	F-5
Consolidated statements of cash flows for the years ended December 31, 2002, 2003 and 2004	F-6
Notes to the consolidated financial statements	F-7

(b) Exhibits filed as part of this Amendment No. 1**Exhibit No. Description**

12.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act.
12.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act.
13.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
13.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F/A and that it has duly caused and authorized the undersigned to sign this Amendment No. 1 on its behalf.

GRAVITY CO., LTD

By: /s/ Il Young Ryu

Name: Il Young Ryu

Title: Representative Director and Chief Executive Officer

Date: May 12, 2006

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GRAVITY Co., Ltd.

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At December 31, 2003 and 2004

and for the years ended December 31, 2002, 2003 and 2004

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Consolidated balance sheets as of December 31, 2003 and 2004	F-3
Consolidated statements of operations for the years ended December 31, 2002, 2003 and 2004	F-4
Consolidated statements of changes in shareholders' equity for the years ended December 31, 2002, 2003 and 2004	F-5
Consolidated statements of cash flows for the years ended December 31, 2002, 2003 and 2004	F-6
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Report of Independent Registered Public Accounting Firm

To the Board of Directors and the Shareholders of
GRAVITY Co., Ltd.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in shareholders' equity and of cash flows, after the restatement described in Note 2, present fairly, in all material respects, the financial position of GRAVITY Co., Ltd. and its subsidiary (the Company) as of December 31, 2003 and 2004 and the results of their operations and their cash flows for the years ended December 31, 2002, 2003 and 2004 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Samil PricewaterhouseCoopers

Seoul, Korea

June 29, 2005, except for Note 2,
as to which date is May 10, 2006

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GRAVITY Co., Ltd.
Consolidated Balance Sheets
December 31, 2003 and 2004

(in millions of Korean Won and in thousands of US dollars, except per share data)

	2003	2004	(Note 4)
	Restated	Restated	2004
			Restated
			(unaudited)
Assets			
Current assets			
Cash and cash equivalents	₩ 5,405	₩ 16,405	\$ 16,888
Short-term financial instruments	1,600	8,900	9,162
Accounts receivable, net	7,011	7,377	7,594
Misappropriated funds receivable-current		7,482	7,702
Deferred expense	963	2,588	2,664
Other current assets	2,845	4,116	4,237
Total current assets	17,824	46,868	48,247
Property and equipment, net	5,417	14,760	15,195
Leasehold and other deposits	3,913	4,192	4,316
Misappropriated funds receivable-non current	7,441		
Other non-current assets	1,829	2,824	2,907
Total assets	₩ 36,424	₩ 68,644	\$ 70,665
Liabilities and Shareholders Equity			
Current liabilities			
Accounts payable	₩ 2,518	₩ 3,742	\$ 3,852
Deferred income	3,409	5,639	5,805
Current portion of long-term debt	2,630	1,150	1,184
Accrued interest	749	318	327
Income tax payable	1,109	1,172	1,207
Other current liabilities	160	200	206
Total current liabilities	10,575	12,221	12,581
Long-term deferred income	849	1,958	2,016
Long-term debt	1,046		
Accrued severance benefits	342	960	988
Leasehold deposit received		2,000	2,059
Long-term accounts payable	1,138	1,063	1,094
Other non-current liabilities	10	7	7
Total liabilities	13,960	18,209	18,745
Commitments and contingencies			
Shareholders equity			
Preferred shares, ₩500 par value, 2,000,000 shares authorized, and no shares issued and outstanding at December 31, 2003 and 2004,			

respectively

Common shares, ₩500 par value, 38,000,000 shares authorized, and
5,548,900 shares issued and outstanding as of December 31, 2003

and 2004, respectively

	2,774	2,774	2,856
Additional paid-in capital	2,132	2,181	2,245
Retained earnings	17,560	45,617	46,960
Accumulated other comprehensive loss	(2)	(137)	(141)
Total shareholders' equity	22,464	50,435	51,920
Total liabilities and shareholders' equity	₩ 36,424	₩ 68,644	\$ 70,665

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

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GRAVITY Co., Ltd.
Consolidated Statements of Operations
For the Years Ended December 31, 2002, 2003 and 2004

*(in millions of Korean Won and in thousands
of US dollars, except per share data)*

	2002	2003	2004	(Note 4)
	Restated	Restated	Restated	2004
				Restated
				(unaudited)
Revenues				
Online games-subscription revenue	₩ 7,310	₩ 18,560	₩ 16,253	\$ 16,732
Online games-royalties and license fees	2,330	29,727	45,101	46,429
Mobile games		43	376	387
Character merchandising, animation and other revenue	427	1,185	2,696	2,775
Total net revenues	10,067	49,515	64,426	66,323
Cost of revenues	1,738	6,958	10,116	10,414
Gross profit	8,329	42,557	54,310	55,909
Operating expenses				
Selling, general and administrative	4,870	11,360	13,660	14,062
Research and development	815	1,597	2,029	2,089
Operating income	2,644	29,600	38,621	39,758
Other income (expenses) Interest income	84	94	479	493
Interest expense	(2,583)	(6,465)	(4,732)	(4,871)
Foreign currency gains	93	413	430	442
Foreign currency losses	(17)	(278)	(1,055)	(1,086)
Others, net	(1)	26	(1)	(1)
Income before income tax expenses, minority interest, and equity in loss of related joint venture	220	23,390	33,742	34,735
Income tax expenses	542	4,250	5,406	5,565
Income before minority interest and equity in loss of related joint venture	(322)	19,140	28,336	29,170
Minority interest			(17)	(18)
Equity in loss of related joint venture			296	305
Net income (loss)	₩ (322)	₩ 19,140	₩ 28,057	\$ 28,883
Earnings per share				
Basic and diluted	₩ (96)	₩ 3,730	₩ 5,056	\$ 5.20
Weighted average number of shares outstanding				
Basic and diluted	3,355,616	5,130,895	5,548,900	5,548,900

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

Table of Contents**GRAVITY Co., Ltd.****Consolidated Statements of Changes in Shareholders' Equity
For the Years Ended December 31, 2002, 2003 and 2004**

<i>(in millions of Korean Won and in thousands of US dollars, except number of shares)</i>	Common Shares	Common Shares	Additional Paid-in Capital	Retained Earnings (Accumulated deficit) Restated	Accumulated Other Comprehensive Income (Loss) Restated	Total Restated
Balance at January 1, 2002	2,800,000	₩ 1,400	₩	₩ (1,258)	₩	₩ 142
Issuance of common shares	600,000	300				300
Comprehensive loss						
Unrealized losses on available-for-sale securities					(210)	(210)
Net loss				(322)		(322)
Total comprehensive loss						(532)
Balance at December 31, 2002	3,400,000	1,700		(1,580)	(210)	(90)
Issuance of common shares	2,148,900	1,074	2,132			3,206
Comprehensive income (loss)						
Unrealized gains on available-for-sale securities					218	218
Cumulative effect of foreign currency translation					(10)	(10)
Net income				19,140		19,140
Total comprehensive income						19,348
Balance at December 31, 2003	5,548,900	2,774	2,132	17,560	(2)	22,464
Amortization of deferred stock compensation			49			49
Comprehensive income (loss)						
Unrealized losses on available-for-sale securities					(11)	(11)
Cumulative effect of foreign currency translation					(124)	(124)
Net income				28,057		28,057
Total comprehensive income						27,922
Balance at December 31, 2004	5,548,900	₩ 2,774	₩ 2,181	₩ 45,617	₩ (137)	₩ 50,435

(Note 4)	Common	Common	Additional Paid-in	Retained Earnings	Accumulated Other Comprehensive	Total
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(unaudited)	Shares	Shares	Capital	Restated	Income (Loss) Restated	Restated
Balance at December 31, 2003	5,548,900	\$ 2,856	\$ 2,195	\$ 18,077	\$ (2)	\$ 23,126
Amortization of deferred stock compensation			50			50
Comprehensive income (loss)						
Unrealized losses on available-for-sale securities					(11)	(11)
Cumulative effect of foreign currency translation					(128)	(128)
Net income				28,883		28,883
Total comprehensive income						28,744
Balance at December 31, 2004	5,548,900	\$ 2,856	\$ 2,245	\$ 46,960	\$ (141)	\$ 51,920

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

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GRAVITY Co., Ltd.
Consolidated Statements of Cash Flows
December 31, 2002, 2003 and 2004

(in millions of Korean Won and in thousands of US dollars)

	2002	2003	2004	(Note 4)
	Restated	Restated	Restated	2004
				Restated
				(unaudited)
Cash flows from operating activities				
Net income (loss)	₩ (322)	₩ 19,140	₩ 28,057	\$ 28,883
Adjustments to reconcile net income (loss) to net cash provided by operating activities				
Depreciation and amortization	594	1,619	3,217	3,312
Provision for accrued severance benefits	140	363	913	940
Loss from impairment on investment		777		
Equity in loss of related joint venture			296	305
Deferred income taxes		(912)	(1,156)	(1,190)
Other	205	256	65	67
Changes in operating assets and liabilities				
Accounts receivable	(6,158)	(1,251)	(498)	(513)
Deferred expense	(1,485)	122	(1,465)	(1,508)
Misappropriated funds receivable	(1,235)	(6,050)	(28)	(29)
Accounts payable	2,062	553	1,221	1,257
Deferred income	50	1,508	3,339	3,437
Accrued interest	1,058	(310)	(417)	(429)
Income tax payable	211	898	63	65
Long-term accounts payable	717	434	4	4
Payment of severance benefits	(15)	(114)	(144)	(148)
Other current liabilities	9	38	148	152
Other assets	(130)	(1,248)	(973)	(1,002)
Net cash provided by (used in) operating activities	(4,299)	15,823	32,642	33,603
Cash flows from investing activities				
Increase in short-term financial instruments		(1,600)	(7,300)	(7,515)
Decrease (increase) of available-for-sale and other investments, net and other investments, net	(58)	(1,793)	151	155
Purchase of equity investments			(1,243)	(1,280)
Purchase of property and equipment	(2,898)	(4,749)	(12,324)	(12,686)
Disposal of property and equipment	381	510	22	23
Payment of leasehold deposits	(945)	(3,527)	(279)	(287)
Proceeds from leasehold deposits		710	2,000	2,059
Others, net		(115)	(34)	(35)
Net cash used in investing activities	(3,520)	(10,564)	(19,007)	(19,566)
Cash flows from financing activities				
Issuance of common stock, net	300	3,206		
Increase of long-term debt	7,500			

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Repayment of capital lease liabilities		(500)	(104)	(107)
Proceeds from borrowings	2,200	8,615		
Repayment of long-term debt	(688)	(3,135)	(2,527)	(2,601)
Repayment of borrowings	(2,753)	(8,600)	(4)	(5)
Net cash provided by (used in) financing activities	6,559	(414)	(2,635)	(2,713)
Net increase(decrease) in cash and cash equivalents	(1,260)	4,845	11,000	11,324
Cash and cash equivalents				
Beginning of year	1,820	560	5,405	5,564
End of the year	₩ 560	₩ 5,405	₩ 16,405	\$ 16,888

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

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GRAVITY Co., Ltd.

Notes to Consolidated Financial Statements

December 31, 2003 and 2004

1. Description of Business

GRAVITY Co., Ltd. (GRAVITY) was incorporated on April 4, 2000 and is engaged in developing and distributing online games and other related businesses principally in the Republic of Korea and in other countries within Asia, America and Europe. GRAVITY 's principal product, a multi-player online role playing game, RAGNAROK , was commercially launched in August 2002.

GRAVITY founded GRAVITY Interactive, LLC, a limited liability company incorporated the State of California (Interactive), as a wholly owned subsidiary, on March 14, 2003. GRAVITY acquired 50% of the voting shares of RO Production Co., Ltd., a company incorporated under the laws of Japan on January 20, 2004. In October 25, 2004, the Company acquired the remaining 50% of the voting shares of RO Production Co., Ltd. The Company changed its corporate name to GRAVITY Entertainment Corp. on February 5, 2005 and after October 25, 2004 is a wholly-owned subsidiary of Gravity. Unless specifically stated otherwise of unless the context otherwise requires, the use of the term Company, we, us or our, refers to the Company and its consolidated subsidiaries.

GRAVITY conducts its business within one industry segment the business of developing and distributing online game, software licensing and other related services.

2. Embezzlement and Restatement

In November 2005, the audit committee of the board of the directors of the Company (the Audit Committee) determined that the Company 's audited consolidated financial statements as of December 31, 2003 and 2004 and for each of the years ended December 31, 2002, 2003 and 2004 (the Original Financial Statements) needed to be restated. The need for a restatement arose from the discovery and subsequent investigation by the Audit Committee (the Investigation) of the diversion of revenues payable to the Company from certain licensees of its Ragnarok Online game to the former Chairman and former controlling shareholder of the Company, Mr. Jung Ryool Kim (the former Chairman). The impact of the diversion was that such revenues and related expenses were improperly omitted from the Original Financial Statements.

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GRAVITY Co., Ltd.

Notes to Consolidated Financial Statements

December 31, 2003 and 2004

The Company has restated its consolidated balance sheets as of December 31, 2003 and 2004 and its consolidated statements of operations, cash flows and change in shareholders' equity for 2002, 2003 and 2004 from the Original Financial Statements to reflect the following, resulting from the findings of the investigation:

- (a) The diversion of revenues attributable to the Company by the former Chairman during the years ended December 31, 2002, 2003 and 2004. These Restated Financial Statements include such revenue in the period when it would have been recognized by the Company, had the diversion not occurred. These amounts are recorded as Misappropriated funds receivable in the restated consolidated balance sheets as of December 31, 2003 and 2004. In addition, the Restated Financial Statements include the recognition of expense for royalty payments due to several third parties relating to the Company's Ragnarok game that were not recognized as expenses in the relevant periods as a result of the diversion of revenues by the former Chairman. The Restated Financial Statements include such expenses as cost of revenue or interest expense, as applicable, in the period when the related revenue is recorded in the restated consolidated statement of operations for the years ended December 31, 2002, 2003 and 2004 and as an amount payable to the relevant parties in the restated consolidated balance sheets as of December 31, 2003 and 2004.
- (b) The misappropriation of certain assets, previously recorded as fixed assets in the Company's consolidated financial statements. The Restated Financial Statements include an adjustment from the Original Financial Statements related to the purchase by the Company of certain assets that were recorded as fixed assets in the Original Financial Statements. The Company determined, based on the Investigation Reports, that these assets could not be identified and management and the audit committee concluded that such assets should have been recorded as expense in the Company's financial statements at their purchase date, as it is unlikely that the Company received any benefit from the purchase of the assets. Additionally, the Original Financial Statements included depreciation expense related to these assets in the years ended December 31, 2003 and 2004. Depreciation expenses have not been recorded in the Restated Financial Statements for the years ended December 31, 2003 and 2004 as the costs of such assets are fully expensed at their acquisition date in these statements.
- (c) Improper and intentional early recognition of certain revenue in connection with the Company's mobile games revenue and character merchandising, animation and other revenue relating to products in the year ended December 31, 2004. Accounting principles generally accepted in the United States of America (US GAAP) requires that revenue should not be recognized until delivery of the product or completion of service. The restated consolidated statement of operations for the year ended December 31, 2004 include adjustments to reduce the amount of revenue recognized in that year as the product contracted for had not been delivered by year end.
- (d) The impact of the above adjustments on foreign currency gains(losses), net is recorded in the Restated Financial Statements due to the timing difference in the recognition of revenue and the receipt of the revenues by the Company.
- (e) The impact of the above adjustments on the provision for income taxes has been reflected in the year in which the items are recorded in the Restated Financial Statements. Which consists of changes in the deferred tax assets and liabilities resulting from the misappropriation by the former Chairman, and increases in penalties and interest payable for inaccurate reporting of taxes in the years when the diversion took place.
- (f) The Company had incorrectly recorded certain foreign tax credits in prior periods. Additionally, the Company had previously amended credits recorded in one period by adjusting the balance of the credits at

the end of the subsequent period. The Restated Financial Statements now reflect the correct foreign tax credits in the year in which they should have been recorded.

The Restated Financial Statements do not reflect all of the issues noted in the Investigation Reports, as certain findings could not ultimately be corroborated based on the available evidence. Subsequent to the discovery of the embezzlement, the former Chairman paid ₩7.8 billion to the Company in October 2005. In addition, the former Chairman has agreed to pay an additional amount to the Company, in part to reimburse the Company for certain of the costs and expenses incurred by the Company in connection with the Investigation.

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Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004**

The following sets forth the impact on reported net income (loss) as a result of the items described above:

<i>(In millions of Korean Won)</i>	2002	2003	2004
Net income (loss) as previously reported	₩ (496)	₩ 14,669	₩ 29,201
(a) Adjustment due to diversion of revenue by the former Chairman including related expenses	231	6,506	430
(b) Adjustments due to misappropriation of certain assets		(277)	87
(c) Improper and intentional early recognition of revenue including related expenses			(748)
(d) Foreign currency gains (losses) effect of the above adjustments	18	(43)	91
(e) Tax effect of the above adjustments	(75)	(1,957)	(180)
(f) Error in recording foreign tax credit		242	(824)
Total adjustments	174	4,471	(1,144)
Net income (loss) as restated	₩ (322)	₩ 19,140	₩ 28,057

The following sets forth the impact on reported retained earnings as a result of the items discussed above:

<i>(In millions of Korean Won)</i>	2003	2004
Retained earning as previously reported	₩ 12,916	₩ 42,117
(a) Adjustment due to diversion of revenue by the former Chairman including related expenses	6,737	7,167
(b) Adjustments due to misappropriation of certain assets	(277)	(190)
(c) Improper and intentional early recognition of revenue including related expenses		(748)
(d) Foreign currency gains (losses) effect of above adjustments	(26)	65
(e) Tax effect of the above adjustments	(2,032)	(2,212)
(f) Error in recording foreign tax credit	242	(582)
Total adjustments	4,644	3,500
Retained earning as restated	₩ 17,560	₩ 45,617

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004**

The following sets forth the impact on the Company's statements of operations as a result of the items discussed above:

<i>(In millions of Korean Won)</i>	For the year ended December 31,					
	2002		2003		2004	
	(As previously reported)	(As restated)	(As previously reported)	(As restated)	(As previously reported)	(As restated)
Revenues						
Online games-royalties and license fees	₩ 2,079	₩ 2,330	₩ 22,804	₩ 29,727	₩ 44,236	₩ 45,101
Mobile games			43	43	480	376
Character merchandising, animation and other	427	427	1,024	1,185	3,471	2,696
Total net revenues	9,816	10,067	42,431	49,515	64,440	64,426
Cost of revenues	1,735	1,738	6,866	6,958	10,309	10,116
Operating Expenses	5,771	5,685	12,712	12,957	15,749	15,689
Other income						
(expense)-interest expense	(2,480)	(2,583)	(5,947)	(6,465)	(4,309)	(4,732)
Other income						
(expense)-foreign currency translation	58	76	178	135	(716)	(625)
Income tax expenses	467	542	2,535	4,250	4,402	5,406
Equity in loss of related joint venture					(248)	(296)
Net income (loss)	₩ (496)	₩ (322)	₩ 14,669	₩ 19,140	₩ 29,201	₩ 28,057

The following sets forth the impact on the Company's balance sheet as a result of the items discussed above:

<i>(In millions of Korean Won)</i>	As of the year ended December 31,			
	2003		2004	
	(As previously reported)	(As restated)	(As previously reported)	(As restated)
Assets:				
Accounts receivable, net	₩ 6,988	₩ 7,011	₩ 7,321	₩ 7,377
Misappropriated funds receivable-current				7,482
Deferred expense	651	963	2,530	2,588
Current deferred income tax asset	504	536	2,684	1,692
Other current assets	2,156	2,309	2,258	2,424
Total current assets	17,304	17,824	40,098	46,868
Property and equipment, net	5,694	5,417	14,951	14,760
Misappropriated funds receivable-non current		7,441		
Other non current assets	1,854	1,829	2,893	2,824
Total assets	₩ 28,765	₩ 36,424	₩ 62,134	₩ 68,644

Liabilities:

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Accounts Payable	₩ 2,432	₩ 2,518	₩ 3,576	₩ 3,742
Deferred income	2,671	3,409	4,392	5,639
Current portion of long-term debt	2,633	2,630	1,278	1,150
Accrued interest	678	749	271	318
Income tax payable	476	1,109	478	1,172
Other current liabilities	161	160	324	200
Total current liabilities	9,051	10,575	10,319	12,221
Long-term deferred income	380	849	1,918	1,958
Long-term debt	1,164	1,046		
Long-term accounts payable		1,138		1,063
Other non current liabilities	8	10	7	7
Total liabilities	10,945	13,960	15,204	18,209
Retained earnings	12,916	17,560	42,117	45,617
Accumulated other comprehensive loss	(2)	(2)	(141)	(137)
Total shareholder s equity	17,820	22,464	46,930	50,435
Total liabilities and shareholder s equity	₩ 28,765	₩ 36,424	₩ 62,134	₩ 68,644

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**GRAVITY Co., Ltd.
Notes to Consolidated Financial Statements
December 31, 2003 and 2004**

Total assets

As a result of activities which necessitated the restatements to the Company's Original Financial Statements, our total assets increased by ₩7,659 million and ₩6,510 million in 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements principally due to the recognition of Misappropriated funds receivable-non current of ₩7,441 million in 2003, and the recognition of Misappropriated funds receivable-current of ₩7,482 million in 2004. This represents the amounts diverted by the former chairman and, therefore due to the Company as of December 31, 2003 and 2004.

In addition, there were certain adjustments to deferred expense, accounts receivable, net, current deferred income tax asset and other current assets in each of the years presented.

Total liabilities

As a result of activities which necessitated the restatements to the Company's Original Financial Statements, total liabilities increased by ₩3,015 million and ₩3,005 million in 2003 and 2004, respectively, from the previously reported amounts, principally due to the following adjustments:

Deferred income increased by ₩738 million and ₩1,247 million in 2003 and 2004, respectively, and long-term deferred income increased by ₩469 million and ₩40 million in 2003 and 2004, respectively. In each year, the adjustments are due to increases in initial license fees which are being recognized over the relevant contract terms, resulting from the former Chairman's diversion of licensee fee payments due to the Company and the impact of the improper and early recognition of revenues relating to the Company's mobile games and character merchandising, animation and other revenues in 2004;

Income tax payable increased by ₩633 million and ₩694 million in 2003 and 2004, respectively, due to the recognition of certain tax penalties as a result of the underpayment of income taxes in the relevant periods; and

Long-term accounts payable increased by ₩1,138 million and ₩1,063 million in 2003 and 2004, respectively, due to the recording of additional payments due to certain third parties as a result of the increase in revenues in such year.

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GRAVITY Co., Ltd.

Notes to Consolidated Financial Statements

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Effect on Consolidated Statements of Cash Flows:

As a result of activities which necessitated the restatements to the Company's Original Financial Statements, Net cash provided by (used in) operating activities increased ~~₩15 million~~, ~~₩106 million~~ and ~~₩8 million~~ in 2002, 2003 and 2004, respectively, and Net cash provided by (used in) financing activities decreased by the same amount in 2002, 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements, due to the reclassification between Accrued interest in Cash flows from operating activities and Repayment of long-term debt, as a result of the imputed interest rate relating to Long-term loan was changed.

In addition, on December 26, 2003, the Company borrowed loans of ~~₩4,600 million~~ from three banks and repaid the same amount in five days which had not been recorded in previously reported amounts in the Original Financial Statements.

Effect on Consolidated Statements of Change in Shareholders' Equity:

As a result of activities which necessitated the restatements to the Company's Original Financial Statements, total shareholders' equity increased by ~~₩173 million~~, ~~₩4,644 million~~ and ~~₩3,505 million~~ in 2002, 2003 and 2004, respectively, from the previously reported amounts in the Original Financial Statements of ~~₩(263) million~~, ~~₩17,820 million~~ and ~~₩46,930 million~~ in 2002, 2003 and 2004, respectively, to ~~₩(90) million~~, ~~₩22,464 million~~ and ~~₩50,435 million~~ in 2002, 2003 and 2004, respectively, principally due to the decrease in net loss in 2002 and increase in net income in 2003 and 2004.

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GRAVITY Co., Ltd.

Notes to Consolidated Financial Statements

December 31, 2003 and 2004

3. Significant Accounting Policies

Basis of presentation

The accompanying consolidated financial statements have been prepared in accordance with US GAAP. Significant accounting policies followed by the Company in the preparation of the accompanying consolidated financial statements are summarized below.

Principles of consolidation

The accompanying consolidated financial statements include the accounts of GRAVITY and its subsidiaries, GRAVITY Interactive, LLC. and RO Production Co., Ltd (the Company). All significant intercompany transactions and balances have been eliminated in the consolidation.

Investments in entities where the Company holds more than a 20% but less than a 50% ownership interest and have the ability to significantly influence the operations of the investee are accounted for using the equity method of accounting and our share of the investee's operation is included in equity method investee. The Company follows the equity method of accounting for investment in its joint venture of Animation Production Committee. The Company records its initial investment at cost and records its pro rata share of the earnings in or losses in the results of operations of the venture.

Stock split

On November 22, 2003, the Company's shareholders approved a 10-for-1 stock split, which became effective on December 25, 2003. The accompanying consolidated financial statements, including all share and per share data, have been restated as if the stock split had occurred as of the earliest period presented.

Use of estimates

The preparation of consolidated financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the accompanying consolidated financial statements and related disclosures. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may differ from these estimates.

Risks and Uncertainties

The industry in which the Company operates is subject to a number of industry-specific risks, including, but not limited to, rapidly changing technologies; significant numbers of new competitive entrants; dependence on key individuals; competition from similar products from larger companies; customer preferences; the need for the continued successful development, marketing, and selling of its products and services; and the need for positive cash flows from operations. The Company depends on one key product, RAGNAROK and has a limited operating history and as a result, the Company is subject to risks associated with early stage companies in new and rapidly evolving markets.

During the years ended December 31, 2002, 2003 and 2004, the Company generated 99%, 95% and 94% of its revenues from countries in Asia, respectively. Any economic downturn or crisis in Asia would have a significant negative impact on the Company.

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GRAVITY Co., Ltd.

Notes to Consolidated Financial Statements

December 31, 2003 and 2004

During the years ended December 31, 2002, 2003 and 2004, the Company generated a 71%, 33% and 20%, respectively, of its total revenue from its relationship with Sunny YNK, Inc. (Sunny YNK) in Korea, which are reported as online games - subscription revenue in the Company's statement of operations. In addition, during the years ended December 31, 2002, 2003 and 2004, the Company generated 26%, 49%, and 51%, respectively, of its total revenues from two of its customers, the licensees in Japan and Taiwan. Revenue attributable to the Company's licensee in Japan were 11%, 25% and 29% of the Company's total revenues in 2002, 2003 and 2004, respectively, and the revenue attributable to the Company's licensee in Taiwan accounted for 15%, 24% and 23% of the Company's total revenues in 2002, 2003 and 2004, respectively.

Start-up costs

Start-up costs are expensed as incurred.

Revenue recognition

Online games- subscription revenue

Prepaid online game subscriptions are deferred and recognized when actually used.

Online games-royalties and license fees

The Company licenses the right to sell and distribute its games in exchange for an initial prepaid license fee and guaranteed minimum royalty payments. The prepaid license fee revenues are deferred and recognized ratably over the license period. The guaranteed minimum royalty payments, which are currently only paid in China, are deferred and recognized as the royalties are earned. In addition, the Company receives a royalty payment based on a specified percentage of the licensees' sales. These royalties, that exceed the guaranteed minimum royalty, are recognized on a monthly basis, as the related revenues are earned by the licensees.

In February and April, 2002, the Company entered into agreements with Sunny YNK, Inc. (Sunny YNK) pursuant to which the Company granted it the exclusive right to distribute RAGNAROK in Korea for a contractual period of three years from the date RAGNAROK was first commercialized. The Company acts as the primary obligor with the end-user, and in the majority of situations the end-user is not aware of the existence of Sunny YNK. The game is marketed and branded by the Company, and it takes full responsibility for any customer complaints, questions, support and is responsible to fix any bugs that are identified. The Company develops content and maintains legal ownership of the copyrights to the games. It hosts the delivery of the games on its servers and can refuse end-users from participating in game play. The Company has the right to stop providing services to support the game at any time. In accordance with Emerging Issues Task Force (EITF) No. 99-19, *Reporting Revenue Gross versus Net*, the Company presents the entire revenue derived from the Sunny YNK license arrangement in its statement of operations.

Cash and cash equivalents

Cash equivalents consist of highly liquid investments with an original maturity date of three months or less.

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004****Short-term financial instruments**

Short-term financial instruments include time deposits, with maturities greater than three months but less than a year.

Available-for-sale investments

Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of comprehensive income in stockholders' equity.

Allowance for doubtful accounts

The Company maintains allowances for doubtful accounts receivable based upon the following information: an aging analysis of its accounts receivable balances, historical bad debt rates, repayment patterns and creditworthiness of its customers, and industry trend analysis.

Subsequent to June 2003, pursuant to agreements with various payment gateway providers, the payment gateway providers are responsible for remitting to the Company the full subscription revenues generated in Korea after deducting their fixed service fees and charges, which range from approximately 9% to 13% and risk of loss or delinquencies are borne by such payment gateway providers.

Property and equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation for Computer and equipment, furniture and fixtures, vehicles, capital lease assets and purchased software is computed using the straight-line method over the following estimated useful lives:

	40
Building	years
Computer and equipment	4 years
Furniture and fixtures	4 years
Software	3 years
Vehicles	4 years
Capital lease assets	4 years

Leasehold improvements are amortized on a straight-line basis over the estimated useful life of the assets or the lease term, whichever is shorter.

Significant renewals and additions are capitalized at cost. Maintenance and repairs are charged to income as incurred.

Accounting for the impairment of long-lived assets

Long-lived assets and intangible assets that do not have indefinite lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. When the aggregate of future cash flows (undiscounted and without interest charges) is less than the carrying value of the asset, an impairment loss is recognized based on the fair value of the asset.

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Capitalized software development costs

The Company capitalizes certain software development costs relating to online games that will be distributed through subscriptions or licenses. The Company accounts for software development in accordance with Statements of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Software development costs incurred prior to the establishment of technological feasibility are expensed when incurred and are included in research and development expense. Once a software product has reached technological feasibility, then all subsequent software development costs for that product are capitalized until the product is commercially launched. Technological feasibility is evaluated on a product-by-product basis, but typically occurs when the online game has a proven ability to operate in a massively multi-player format. Technological feasibility of a product encompasses both technical design documentation and game design documentation. For products where proven technology exists, this may occur early in the development cycle.

After an online game is released, the capitalized product development costs are amortized over the game's estimated useful life, which is deemed to be three years. This expense is recorded as a component of cost of revenues.

Capitalized software development costs net of accumulated amortization at December 31, 2003 and 2004 was ₩255 million and ₩468 million, respectively, which is included in the other non-current assets of the accompanying balance sheets. Amortization expense for fiscal years ended December 31, 2002, 2003 and 2004 was ₩59 million, ₩157 million and ₩199 million, respectively.

The Company evaluates the recoverability of capitalized software development costs on a product-by-product basis. The recoverability of capitalized software development costs is evaluated based on the expected performance of the specific products for which the costs relate. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based. Capitalized costs for those products that are cancelled are expensed in the period of cancellation. In addition, a charge to cost of revenues is recorded when management's forecast for a particular game indicates that unamortized capitalized costs exceed the net realizable value of that asset. Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established, as well as in the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional development costs to be incurred. If revised forecasted or actual product sales are less than and/or revised forecasted or actual costs are greater than the original forecasted amounts utilized in the initial recoverability analysis, the actual impairment charge may be larger than originally estimated in any given period.

Research and development costs

Research and development costs consist primarily of payroll, depreciation expense and other overhead expenses which are all expensed as incurred until technological feasibility is reached.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2004

Advertising

The Company expenses advertising costs as incurred. Advertising expense was approximately ₩1,334 million, ₩4,233 million and ₩4,614 million for the years ended December 31, 2002, 2003 and 2004, respectively. Pursuant to the terms of the agreement with Sunny YNK once the cumulative royalty payments to Sunny YNK reached ₩7 billion it is required to use 15% of future royalty payments, paid by the Company, to fund additional marketing of the RAGNAROK game. In March 2003, cumulative royalty payments to Sunny YNK reached ₩7 billion. After January 1, 2004, these marketing activities were performed by the Company and therefore, Sunny YNK reimbursed the Company for these costs, which was credited to advertising expenses within selling, general and administrative expenses in the accompanying statement of operations.

Accrued severance benefits

Employees and directors with one year or more of service are entitled to receive a lump-sum payment upon termination of their employment with the Company based on the length of service and rate of pay at the time of termination. Accrued severance benefits are estimated assuming all eligible employees were to terminate their employment at the balance sheet date. The annual severance benefits expense charged to operations is calculated based upon the net change in the accrued severance benefits payable at the balance sheet date.

Accrued severance benefits are funded through a group severance insurance plan. The amounts funded under this insurance plan are classified as a deduction to the accrued severance benefits.

Foreign currency translation

The Korean parent company and its subsidiary use their local currencies as their functional currencies. All assets and liabilities of the foreign subsidiary are translated into the Korean Won at the exchange rate in effect at the end of the period, and revenues and expenses are translated at average exchange rates during the period. The effects of foreign currency translation adjustments are reflected in the cumulative translation adjustment account in comprehensive income of shareholders' equity.

Foreign currency transactions

Net gains and losses resulting from foreign exchanges transactions are included in foreign currency gains (losses) in the statement of operations.

Income taxes

The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes*. Under SFAS No. 109, income taxes are accounted for under the asset and liability method. Deferred taxes are determined based upon differences between the financial reporting and tax bases of assets and liabilities at currently enacted statutory tax rates for the years in which the differences are expected to reverse.

A valuation allowance is provided on deferred tax assets to the extent that it is more likely than not that such deferred tax assets will not be realized. The total income tax provision includes current tax expenses under applicable tax regulations and the change in the balance of deferred tax assets and liabilities.

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GRAVITY Co., Ltd.

Notes to Consolidated Financial Statements

December 31, 2003 and 2004

Fair value of financial instruments

The Company's carrying amounts of cash, cash equivalents, short-term financial instruments, accounts receivable, accounts payable and accrued liabilities approximate fair value because of the short maturity of these instruments.

Accounting for Stock-Based Compensation

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of SFAS No. 123, Accounting for Stock Based Compensation, using the fair value method. Under this method, compensation cost for stock option grants are measured at the grant date based on the fair value of the award and recognized over the service period, which is usually the vesting period, using the method promulgated by Financial Accounting Standards Board (FASB) Interpretations No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28).

The Company uses a Black-Scholes model to determine the fair value of equity-based awards at the date of grant and recognizes compensation cost as if all awards are expected vest, recognizing forfeitures as they occur.

Earnings per Share

Basic earnings per share is computed by dividing net income attributable to common shareholders by the weighted average number of common shares outstanding for all periods. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding, increased by common stock equivalents. Common stock equivalents are calculated using the treasury stock method and represent incremental shares issuable upon exercise of the Company's outstanding stock options. However, potential common shares are not included in the denominator of the diluted earnings per share calculation when inclusion of such shares would be anti-dilutive, such as in a period in which a net loss is recorded.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123 (R), Share-Based Payment which requires that the cost resulting from equity-based compensation transactions be recognized in the financial statements using a fair-value-based method. The Statement replaces SFAS No. 123, supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS No. 95, Statement of Cash Flows. The new statement will be effective for public entities in fiscal years beginning after June 15, 2005. The fair value method under SFAS No. 123(R) is the same method used to fair value options under SFAS No. 123, which would result in the same measurement and recognition of stock-based compensation. Therefore, the impact of adopting SFAS No. 123(R), will not have any impacts on the results of operations, and only have certain additional required disclosures.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. This Statement amends Opinion 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. The Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not expect a significant impact on its results of operations and

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004**

disclosures.

In May 2005, the FASB issued SFAS 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. This Statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This standard is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will have no impacts upon adoption of this standard as no accounting changes or errors have occurred in the current period.

4. Convenience Translation into United States Dollar Amounts

The Company reports its consolidated financial statements in the Korean Won. The United States dollar (US dollar) amounts disclosed in the accompanying financial statements are presented solely for the convenience of the reader, and have been converted at the rate of 971.4 Korean Won to one US dollar, which is the noon buying rate of the US Federal Reserve Bank of New York in effect on March 31, 2006. Such translations should not be construed as representations that the Korean Won amounts represent, have been, or could be, converted into, US dollars at that or any other rate. The US dollar amounts are unaudited and are not presented in accordance with generally accepted accounting principles either in Korea or the United States of America.

5. Allowance for Accounts receivable

Changes in the allowance for accounts receivable for the years ended December 31, 2002, 2003 and 2004 are as follows:

<i>(In millions of Korean Won)</i>	2002	2003	2004
Balance at beginning of year	₩	₩ 151	₩ 242
Provision for allowances	151	91	
Write-offs			242
Balance at end of year	₩ 151	₩ 242	₩

6. Investment in equity method investee

In April 2004, its subsidiary, RO Production Co., Ltd. invested JPY 123 million for a 30% interest in Animation Production Committee , a joint venture. The investment was accounted for under the equity method of accounting and it is included in the other non current assets of the accompanying balance sheets.

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004****7. Property and Equipment, Net**

Property and equipment as of December 31, 2003 and 2004 consist of the following:

<i>(In millions of Korean Won)</i>	2003 Restated	2004 Restated
Land	₩	₩ 5,954
Building		2,234
Computer and equipment	3,255	5,427
Furniture and fixtures	440	537
Vehicles	194	190
Capital lease assets	603	
Leasehold improvements	975	1,043
Software externally-purchased	1,886	4,200
	7,353	19,585
Less: accumulated depreciation	1,936	4,825
	₩ 5,417	₩ 14,760

Depreciation expenses for the years ended December 31, 2002, 2003 and 2004, were ₩535 million, ₩1,459 million and ₩2,989 million, respectively, which includes depreciation expense of capital lease assets of ₩134 million and ₩30 million for the years ended December 31, 2003 and 2004, respectively.

As of December 31, 2004, the Company's land and buildings were pledged as collateral for leasehold deposits which amounted to ₩2,600 million.

8. Accrued Severance Benefits

Changes in accrued severance benefits for the years ended December 31, 2002, 2003 and 2004 are as follows:

<i>(In millions of Korean Won)</i>	2002	2003	2004
Balance at beginning of year	₩ 39	₩ 164	₩ 413
Provisions for severance benefits	140	363	913
Severance payments	(15)	(114)	(144)
	164	413	1,182
Less: amounts placed on deposit with insurance company		(71)	(222)
Balance at end of year	₩ 164	₩ 342	₩ 960

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As of December 31, 2004, the Company would be required to pay the following future benefits to its employees as of such date upon their normal retirement age of fifty five:

(In millions of Korean Won)

2005	₩	1
2006		
2007		2
2008		3
2009		6
2010~2014		57

The above amounts were determined based on the salary levels of existing employees as of such date and the number of service years that will be accumulated upon their retirement. These amounts do not include amounts that might be paid to employees who may cease working with the Company prior to their normal retirement age.

9. Long-term debt

In February and April, 2002, the Company entered into agreements with Sunny YNK, pursuant to which the Company granted it the exclusive right to distribute RAGNAROK for a contractual period of three years from the date RAGNAROK was first commercialized. As a result of the receipt of exclusive distribution rights, Sunny YNK loaned the Company ₩ 7,000 million at the inception of the agreement, which it is accounted as debt in the accompanying balance sheets, in accordance with EITF No. 88-18, *Sales of Future Revenues*.

As there is no interest rate stated in the agreement with Sunny YNK, the interest is imputed based on the difference between the principal amount of the loan and the total payments expected to be made pursuant to the agreements. Accordingly, the repayment of principal amounts to Sunny YNK is variable each year in accordance with amount of annual revenue generated from distribution of RAGNAROK and deduction of annual interest expense allocated using the interest rate method.

<i>(In millions of Korean Won)</i>	2003 Restated	2004 Restated
Loans, representing obligations principally to Sunny YNK Inc		
Due 2005	₩ 3,676	₩ 1,150
Less: Current portion	(2,630)	(1,150)
	₩ 1,046	₩

In accordance with these agreements with Sunny YNK, during the years ended December 31, 2003 and 2004, the Company made payments of ₩7,923 million and ₩6,670 million, respectively to Sunny YNK. Additionally the Company accrued ₩403 million and ₩367 million due to Sunny YNK in 2003 and 2004, respectively. Of these loan amounts, ₩ 2,843 million and ₩ 2,391 million were allocated to principal, and ₩ 5,483 million and ₩ 4,646 million were allocated to interest, in 2003 and 2004, respectively.

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004****10. Commitments and Contingencies**

The Company leases certain equipment and property. The Company's operating lease consists of a property lease expiring on December 31, 2005. Rental expense incurred under this operating lease were approximately ₩ 346 million, ₩ 769 million and ₩ 956 million for the years ended December 31, 2002, 2003 and 2004, respectively. The Company's equipment capital lease agreement expired in March 2004.

Future minimum lease payments for the leases as of December 31, 2004, are as follows:

(In millions of Korean Won)

	2005	2006
Operating lease	₩ 728	₩ 5

11. Shareholders' Equity

As of December 31, 2004, GRAVITY is authorized to issue a total of 40 million shares with a par value of ₩500 per share, in registered form, consisting of common shares and non-voting preferred shares. Of this authorized amount, GRAVITY is authorized to issue up to 2 million non-voting preferred shares. Under the articles of incorporation, holders of non-voting preferred shares are entitled to dividends of not less than 1% and up to 15% of the par value of such shares the exact rate to be determined by GRAVITY's board of directors at the time of issuance, provided that the holders of preferred shares are entitled to receive dividend at a rate not lower than that determined for holders of common shares. Gravity does not have any non-voting preferred shares outstanding.

On March 14, 2003, GRAVITY issued 2,148,900 common shares for ₩ 1,500 per share. GRAVITY recorded total gross proceeds of ₩ 3,206 million, net of issuance costs in the amount of ₩ 17 million.

On November 22, 2003, GRAVITY's shareholders approved a 10-for-1 stock split which became effective on December 25, 2003. GRAVITY's shareholders received nine additional shares for each share they owned as of record date of October 27, 2003. All share data has been restated to reflect such stock split for all periods presented.

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004****12. Stock purchase option plan**

On December 24, 2004, the Company's shareholders approved the stock purchase option plan (the Plan). The Plan provides for the grant of incentive stock options to employees and directors. On December 24, 2004, the Company granted certain employees options to purchase 271,000 shares of the Company's common stock at an exercise price of ₩ 80,000 or ₩ 70,000 per share. The fair value of the options at the date of the grant is estimated using the Black-Scholes option pricing model. In accordance with the Plan, all of options granted in 2004 vest over four year period, with 25% vesting after two years of continued employment, 25% vesting after three years of continued employment, 25% vesting after four years of continued employment, and the remaining 25% vesting after five years from the grant date. The options that have vested for each period must be exercised within one year from the vesting date, and options that have not been exercised during the each period shall be deemed to be terminated.

A summary of activity under the Plan is as follows:

	Number of Stock Options	Weighted-Average Exercise Price Per Share	Weighted-Average Fair value at Date of Grant
Stock options outstanding as of December 31, 2003	₩ 271,000	₩ 71,845	₩ 20,211
Options granted			
Options exercised			
Options forfeited			
Stock options outstanding as of December 31, 2004	₩ 271,000	₩ 71,845	₩ 20,211

The total compensation expense relating to the grant of stock options on December 24, 2004, ₩ 5,477 million, is recognized over the five year vesting period using the FIN 28. For the year ended December 31, 2004, the Company recognized ₩ 48 million in stock compensation expense for the shares granted. Stock compensation expenses are included in selling, general and administrative expenses and cost of revenue in the statements of operations. There were no exercisable options at December 31, 2004.

The fair value for each option was estimated, at the date of grant, using the Black Scholes option pricing model, with the following weighted average assumptions:

Expected dividend yield	0%
Risk-free interest rate	3.50%
Expected volatility	53%
Expected life (in years from vesting)	4.0 years
Fair value of stock	₩ 55,431

The fair value of the stock at the date of grant was based on the initial public offering price of the Company's American depositary shares on Nasdaq on February 8, 2005, adjusted for the ratio of common stock to ADSs.

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004**

In February 2005, in accordance with the terms of the stock options granted, the exercise prices for the outstanding options were adjusted to the IPO price for officers, and to the IPO price minus ₩ 10,000 for employees. This repricing created a new measurement date for the Company's stock compensation expenses.

13. Earnings per Share

The components of basic and diluted earnings per share are as follows:

*(In millions of Korean Won,
except numbers of common
shares and per share amounts)*

	2002	2003	2004
	Restated	Restated	Restated
Net income available for common shareholders (A)	₩ (322)	₩ 19,140	₩ 28,057
Weighted average outstanding shares of common shares (B)	3,355,616	5,130,895	5,548,900
Earnings per share			
Basic and diluted (A/B)	₩ (96)	₩ 3,730	₩ 5,056

The 271,000 stock options outstanding at December 31, 2004 are excluded from the Company's calculation of earnings per share as their effect is antidilutive.

14. Income Taxes

Income tax expense for the years ended December 31, 2002, 2003 and 2004 consist of the following:

	2002	2003	2004
	Restated	Restated	Restated
<i>(In millions of Korean Won)</i>			
Income before income taxes			
Domestic	₩ 220	₩ 22,332	₩ 33,338
Foreign		1,058	404
	220	23,390	33,742
Current income taxes			
Domestic	542	4,868	6,253
Foreign		294	308
	542	5,162	6,561
Deferred income taxes			
Domestic		1,044	1,085
Foreign		(132)	70
		912	1,155
Total income tax expense	₩ 542	₩ 4,250	₩ 5,406

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004**

The preceding table does not reflect the tax effects of unrealized gains and losses on available-for-sale securities. The tax effect of nil, ₩ 1 million and ₩ 2 million for the years ending December 31, 2002, 2003 and 2004 is recorded directly as other comprehensive income within shareholders' equity.

The tax effects of temporary differences that give rise to significant portions of the deferred income tax assets and deferred income tax liabilities as of December 31, 2003 and 2004 are as follows:

<i>(In millions of Korean Won)</i>	2003 (Restated)	2004 (Restated)
Current deferred income tax assets (liabilities)		
Foreign tax credit carryforwards	₩ 583	₩ 1,502
Tax credit carryforwards for research and human resource development		351
Accrued expense	64	9
Accrued income	(31)	(17)
Deferred expense	(79)	(152)
Unrealized gain and losses on securities	(1)	1
Other		(2)
	536	1,692
Less : Valuation allowance		
Less : Other comprehensive income of deferred tax asset (liability)	(1)	1
	₩ 537	₩ 1,691
Non-current deferred income tax assets (liabilities)		
Depreciation and amortization	₩ 193	₩ 142
Impairment on other investment	192	192
Provisions for severance benefits	55	145
Unremitted earnings of subsidiaries	(74)	(111)
Net operating loss carryforwards in Japan		86
Other	9	8
	375	462
Less : Valuation allowance		(86)
	₩ 375	₩ 376

Deferred income tax assets are recognized only to the extent that realization of the related tax benefit is more likely than not. Realization of the future tax benefits related to the deferred tax assets is dependent on many factors, including the Company's ability to generate taxable income within the period during which the temporary differences reverse, the outlook for the economic environment in which the Company operates, and the overall future industry outlook.

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In 2003 and 2004, the Company generated sufficient taxable profits during the years, such that, based on its assessment of the other factors listed above, management has determined that it is more likely than not that the Company will realize its deferred tax assets in the future and, accordingly, has not recorded a valuation allowance at each balance sheet date.

As of December 31, 2004, GRAVITY Entertainment Corp., the Company's 100% owned consolidated subsidiary in Japan, had available loss carryforwards of ₩ 311 million which expire in 2011. Based on this subsidiary's historical and projected net and taxable income, the Company determined that it would not be able to realize these loss carryforwards, and have recognized a valuation allowance of ₩86 million, on the full amount of the available loss carryforwards, at an effective rate expected to be incurred in Japan.

As of December 31, 2004, the Company also has foreign tax credit carryforwards and tax credit carryforwards for research and human resource development of ₩ 1,502 million and ₩ 351 million, respectively, which expire from 2005 to 2009.

The statutory income tax rate, including tax surcharges, applicable to the Company was approximately 29.7% in 2003 and 2004. The statutory income tax rate was amended to 27.5%, effective for fiscal years beginning January 1, 2005 in accordance with the Corporate Income Tax Law amended on December 30, 2003.

As of December 31, 2004, the Company is entitled to a reduced tax rate of 14.85% by virtue of the Special Tax Treatment Control Law of Korea, which is 50% of the statutory tax rate and applied to certain designated venture companies. In the year 2005, the Company will reapply for its designation as a venture company. However it is uncertain as to whether the Company will obtain this designation. However, even if the Company ceases to enjoy the 50% reduction in corporate income tax rate in 2005, the Company will instead be entitled to a special tax exemption of 10% in corporate income tax rate for fiscal year 2005 by virtue of being a small-and medium-sized company. Accordingly, deferred income taxes as of December 31, 2004 were calculated based on the rate of 24.75% and 27.50% for the amounts expected to be realized during the fiscal year 2005, 2006 and thereafter, respectively.

In September 2005, the Company was designated as a venture company and continues to enjoy 50% reduction in corporate income tax rate in 2005 and 2006, which was not reflected in deferred income tax in 2004.

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A reconciliation of income tax expense at the Korean statutory income tax rate to actual income tax expense is as follows:

	2002	2003	2004
<i>(In millions of Korean Won)</i>			
Tax expense at Korean statutory tax rate	₩ 65	₩ 6,947	₩ 10,021
Income tax exemption	(33)	(3,473)	(5,011)
Tax credit carryforwards for research and human resource development			(351)
Foreign tax differential		274	127
Income not assessable for tax purpose		(2)	
Expense not deductible for tax purpose	521	184	139
Change in statutory tax rate	(10)	(72)	139
Change in valuation allowances	(57)	(154)	86
Expiration of unused foreign tax credit			214
Income tax penalties		633	61
Others	56	(89)	(19)
Total income tax expense	₩ 542	₩ 4,250	₩ 5,406

15. Operations by Geographic Area

Geographic information for the years ended December 31, 2002, 2003 and 2004 is based on the location of the distribution entity. Revenues by geographic region are as follows:

	2002	2003	2004
<i>(In millions of Korean Won)</i>			
	Restated	Restated	Restated
Korea	₩ 7,305	₩ 16,475	₩ 13,524
United States	137	2,373	3,528
Japan	1,144	12,180	18,372
Taiwan	1,480	11,969	14,643
Thailand		3,490	5,504
China		2,089	2,842
Other	1	939	6,013
	₩ 10,067	₩ 49,515	₩ 64,426

Table of Contents**GRAVITY Co., Ltd.****Notes to Consolidated Financial Statements****December 31, 2003 and 2004****16. Related Party Transactions**

As of December 31, 2004, the Company provided loans to employees for housing amounting to ₩12 million at an annual interest rate of 9%.

During the years ended December 31, 2002, 2003 and 2004, there were related party transactions with a major shareholder and an equity investee as follows:

<i>(In millions of Korean Won)</i>	2002	2003	2004
	Restated	Restated	Restated
Purchases from related parties	₩ 346	₩ 721	₩ 938
Amounts due from related parties	900	3,800	3,899
Misappropriated funds receivable	1,235	7,441	7,482
Amounts due to related parties			146

A majority of the purchase transactions is rental expense in accordance with agreements between the Company and the former Chairman.

Most of due from balances have resulted from leasehold deposits remitted to its former Chairman. The balances are included in the leasehold and other deposits balance in the accompanying balance sheets.

As explained in Note 2, the Company's former Chairman was found to have diverted revenues otherwise due to the Company. The Company's resulting investigation concluded that ₩7,482 million was diverted by the former chairman from 2002 to 2004. And such amounts were accounted for in the line of item of Misappropriated funds receivable in the accompanying balance sheets. In addition, in March 2003, the former Chairman had misappropriated the Company's cash in the amount of ₩1,623 million and repaid the same amount to the Company, in nine days.

Due to balance represents amount of accrued expenses payable to equity investee. The balance is included in the other current liabilities balance in the accompanying balance sheet.

The former chairman provided guarantee up to a maximum of ₩300 million for the Company's capital lease in February 2003. The capital lease agreement was expired in March 2004.

On February 20, 2003, the Company obtained a loan of ₩3,000 million at an annual interest rate of 18% from IAMBiz Co., Ltd. On September 30, 2003, the company fully repaid the loan to IAMBiz Co., Ltd. On October 1, 2003, IAMBiz Co., Ltd. acquired 4.99% of the company's outstanding common shares. On October 31, 2003, the Company disposed of its sticker photo division, together with mobile phones and digital and other cameras to IAMBiz Co., Ltd. for proceeds of ₩510 million. On December 10, 2003, the Company also disposed of its license to a horse racing game to IAMBiz Co., Ltd. for proceeds of ₩20 million. IAMBiz Co., Ltd. changed its name to Rhoceo Co., Ltd. on November 11, 2004.

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In 2003, the Company invested ₩1,000 million in the mobile business of Rople-net Co., Ltd. which is a subsidiary of Rhoceo Co., Ltd. and recovered ₩223 million and gave up its right for the remainder of investment, and purchased right to do mobile business and software totaling ₩123 million from Rople-net Co., Ltd. In August 2004, the Company also purchased tangible assets totaling ₩53 million from Rople-net Co., Ltd.

17. Supplemental Cash Flow Information and Non-Cash Activities

<i>(in millions of Korean Won)</i>	2002	2003	2004
	Restated	Restated	Restated
Supplemental cash flow information			
Cash paid during the year for income taxes	₩ 542	₩ 4,343	₩ 6,935
Interest paid	1,526	6,773	5,163
	₩ 2,068	₩ 11,116	₩ 12,098
Supplemental non-cash activities			
Increase of available-for-sale securities	₩ 450	₩	₩
Increase of capital lease asset		603	

18. Subsequent event

In January 2005, the Company commercially launched another massively multi-player online role playing game, R.O.S.E. Online.

The Company registered 8,000,000 shares of ADS on the NASDAQ National Market in the United States of America on February 8, 2005. Of the total ADSs registered for sale, the Company sold 5,600,000 ADSs, and the existing shareholders sold 2,400,000 ADSs. Total cash received by the Company after issue costs was ₩71,837 million.

In May 2005, the initial purchasers and shareholders of the ADSs filed a number of class action complaints for violation of the United States federal securities law in the United States District Court for the Southern District of New York. The complaints identify the Company and certain of its officers as defendants, and claim that the Company's registration statement on Form F-1 and the prospectus which constitutes a part of the registration statement used in connection with its initial public offering contained material misstatements. The Company believes that the claims are without merit and intends to defend the case vigorously.

In April and May 2005, the Company entered into share purchase agreements to acquire an aggregate of 88% of voting shares of Trigger Soft Corp.

In June 2005, the Company entered into a publishing agreement with Sonnori Co., Ltd. to publish an online casual game portal STYLIA and has publishing rights for six months in Korea, and for five years in overseas.